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## Realty Shelter Partnerships in a Nutshell


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### I. INTRODUCTION

There continues to be heated discussion about tax reform in the area of real estate tax shelters. In the past few years, the Internal Revenue Service has taken what many feel to be substantively unsupportable moves against the use of real estate partnerships to deliver tax shelter to high bracket investors. The purpose of this Article is to explain the Service's actions against realty partnerships in the context of current manipulations of the partnership form.

### II. THE ESSENCE OF TAX SHELTER

#### A. *In General*

The term "tax shelter" is usually used in one of two ways.[1] The first definition of a tax shelter is an investment through which one pays tax on less cash than one receives. In this sense, a tax-exempt bond is considered a tax shelter because no tax need be paid on its interest income. In an investment in depreciable real estate, a tax shelter in this sense exists in any year in which the depreciation deduction claimed exceeds the amount of cash spent to retire the principal on the outstanding indebtedness.

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[1]The focus of this Article is on investments in partnerships holding depreciable interests in real estate. For a broader discussion of tax shelters and the need to match investor characteristics with those of a particular shelter, see Calkins & Updegraft, *Tax Shelters*, 26 TAX LAW. 493 (1973).

Stated differently, taxable income will be less than the net amount of cash actually received whenever the deduction for the non-cash expense of depreciation exceeds the amount of money actually spent to amortize the indebtedness, a cash expense for which there is no corresponding deduction.[2] Thus, no matter what the other income and expense items in connection with a property, if depreciation is $100 and debt amortization is $80, taxable income will be $20 less than cash received. If there is an overall cash loss, the tax loss will be $20 greater than the cash loss.

Investment advisors who specialize in partnership syndications, however, are likely to respond that their clients who seek "tax shelter" are using the term in a more narrow sense. High-bracket investors seek *surplus* losses that can be used to offset their income from other sources, not merely a stream of income sheltered from tax as in the case of a municipal bond. Cash flow, indeed, may be of little or no immediate interest. An investment in real estate is a tax shelter in this sense whenever the depreciation deduction is greater than the sum of net cash flow plus the amount of principal paid on indebtedness—when, after all the net cash flow and non-deductible expenditures for debt amortization are "sheltered" from tax, there will be surplus losses.

Real estate tax shelters would not be as popular as they are if an investor were permitted to deduct losses only up to the amount of his actual cash investment in an enterprise. Under the Internal Revenue Code, however, the amount of borrowed funds used to acquire a depreciable asset is included in the asset's depreciable cost, or basis, even if the borrower incurs no personal liability on the indebtedness and the only security for repayment is a mortgage of the property acquired. Stated differently, investors may treat the entire cost of a depreciable asset as a depreciable investment by them, even if the asset is acquired entirely with borrowed funds, and even if the asset-acquisition loans are fully non-recourse. The effect of this rule is that investors may claim depreciation and other deductions far in excess of the amount of their actual cash investment.

### *B. Partnerships in Particular*

Realty shelters in the more narrow sense are ineffective unless the individual members of the organization holding the de-

[2]This analysis can be further refined. The essential point is that there is a gap between actual cash expenditures for which there is no current deduction and fictional deductions that are available without actual cash expenditures. Thus, it would be more precise to say that there will be tax shelter in the first sense whenever the fictional depreciation deduction for a non-cash expense exceeds the sum of the non-deductible expenses for debt amortization and capital improvement.

preciable interest may report its surplus losses. Partnerships are tax-reporting, but not tax-paying, entities, and income is taxed to the individual partners with no taxation at the partnership level. Surplus partnership losses, unlike corporate losses, are "passed through" to the individual partners for their use in offsetting income from other sources. However, certain elections are made at the partnership level that bind all the partners, such as the choice of method of computing depreciation. In sum, the partnership computes and reports its various items of income, gain, loss, deduction, and credit, and the individual partners report their allocable shares.

A partner may not deduct his share of partnership losses below his basis in his partnership interest.[3] A partner's initial basis in his partnership interest is the amount of money he contributes to the partnership, plus the adjusted basis of any property he contributes.[4] However, the Code specifically provides that a partner shall be treated as having contributed additional money to the partnership to the extent he shares in partnership liabilities.[5] Under the Treasury Regulations, general partners in a general partnership are automatically allocated a share of partnership liabilities in the same proportion as they share in partnership losses. The Regulations further specify that in the case of a limited partnership, the limited partners may share in partnership liabilities for basis purposes, but are only deemed to share in those liabilities that are fully non-recourse as to the partners and to the partnership.[6] Such non-recourse liabilities are automatically shared by the limited partners in the same proportion they share in profits.[7] The effect is that limited partners may deduct partnership losses far in excess of their cash and property investment in the partnership, provided they share in non-recourse liabilities for basis purposes. Because it is critical to an effective limited partnership tax shelter that liabilities be non-recourse, the partnership agreement should be drafted as a counseling document

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[3]Losses that are currently non-deductible for lack of basis are not permanently lost; in effect, they are placed in a suspense account and become deductible in later years to the extent of subsequent increases in the partner's adjusted basis for his partnership interest. INTERNAL REVENUE CODE of 1954, § 704(d) [hereinafter cited as CODE].

[4]CODE § 722.

[5]CODE § 752(a) provides:

> Any increase in a partner's share of the liabilities of a partnership, or any increase in a partner's individual liabilities by reason of the assumption by such partner of partnership liabilities, shall be considered as a contribution of money by such partner to the partnership.

[6]Treas. Reg. § 1.752-1(e) (1956).

[7]*Id.*

that will clearly alert the client that both initial and subsequent financing must be non-recourse.

What many investors fail to realize is that there is a corollary treatment of liabilities in later years that can result in unanticipated tax liability. Under the Code, a partner is treated as having received a distribution of cash to the extent his share in partnership liabilities is decreased,[8] even though those liabilities are non-recourse. Just as a limited partner automatically receives a share of non-recourse liabilities upon receipt of an interest in profits, he is automatically relieved of his share of partnership liabilities when he parts with his profits interest. Thus, a limited partner who sells or abandons his partnership interest will be charged with a constructive distribution of cash to the extent he is relieved of his share of non-recourse liabilities.[9] The constructive distribution of cash does not retroactively destroy the tax shelter benefits. The partnership losses reported by the limited partner before his withdrawal presumably were used to offset his ordinary income from other sources, whereas the gain on the constructive distribution of cash is capital gain.[10] Even if the recapture provisions require that part or all of what would otherwise be capital gain be treated as ordinary income, the withdrawing partner will have received, in effect, an interest free loan from the Treasury, in the amount of deferred taxes, for the period of deferral. In addition, the losses may have been timed and claimed in years of greatest income from other sources to maximize their benefit under the graduated tax rates.[11] Finally, the withdrawal and resulting constructive distribution may be timed in a year in which offsetting losses are available.

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[8]CODE § 752(b) provides:

> Any decrease in a partner's share of the liabilities of a partnership, or any decrease in a partner's individual liabilities by reason of the assumption by the partnership of such individual liabilities, shall be considered as a distribution of money to the partner by the partnership.

[9]Rev. Rul. 74-40, 1974-1 CUM. BULL. 159:

> Situation 3. Instead of selling his interest L withdraws from the partnership at a time when the adjusted basis of his interest in the partnership is zero and his proportionate share of partnership liabilities, all of which consist of liabilities on which neither he, the other partners nor the partnership have assumed any personal liability, is $15,000.
>
> Accordingly, L is considered to have received a distribution of money from the partnership of $15,000 and realizes a gain of $15,000 determined under the provisions of section 731(a) of the Code.

[10]This is true except insofar as CODE § 751 applies.

[11]The partnership interest may have been acquired at the end of the partner's taxable year to obtain a retroactive allocation of preadmission partnership losses. See Section VIII *infra*.

## III. Key Unsuccessful Challenges

The ability to report ordinary loss deductions far beyond actual economic investment by treating acquisition liabilities as part of depreciable basis is, therefore, central to real estate tax shelters. The Service has lost major challenges to tax shelters in cases that have involved two closely related critical factors: the claim to a depreciable interest by a taxpayer who does not appear to bear the economic burden of depreciation, and the inclusion in depreciable basis of liabilities that appear to exist in form but not in economic reality.[12] Two stunning cases indicate the difficulty in separating and treating these issues and the consequent continued availability of tax shelter not only in excess of, but independent of, actual economic investment.

In *Manuel D. Mayerson,*[13] the taxpayer "purchased" what had been an unprofitable office building by making a minimal down payment and giving for the overwhelming bulk of the purchase price a note the terms of which merit consideration. First, although "interest" payments were to be made monthly, no repayment of principal was required until the expiration of ninety-nine years. Second, the note provided that it was non-recourse as to principal. Thus, the seller could not hold Mayerson personally liable for his promise to pay the principal amount of the note, but was confined to seeking satisfaction out of the property mortgaged as security—which in this case included no property other than that allegedly sold. Third, however, the note was *with* recourse as to the monthly interest payments as they accrued, but for no more, not even for accelerated interest payments on default. Finally, the note provided for substantial discounts if it were paid within three years from the initial closing date. In fact, five years after the closing, Mayerson retired the note with a payment of only sixty percent of its face amount.

The Service's position was "essentially that the purchase-money mortgage . . . was a nullity and that a capital investment in the subject property had not occurred."[14] In economic reality and for tax purposes, the Service claimed, the arrangements were nothing other than a lease with an option to purchase. Because

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[12]See David F. Bolger, 59 T.C. 760 (1973).

> In this connection, we note that the position of the lessor is sometimes also discussed in terms of his not having any basis. What is more, such discussion sometimes confuses the two questions, i.e., existence of a depreciable interest and the measure of basis, of which respondent's briefs herein furnished an excellent example.

*Id.* at 769, n.8.

[13]47 T.C. 340 (1966).

[14]*Id.* at 349.

the note was with recourse only as to interest payments already accrued, Mayerson could walk away from the property at any time with no more personal liability than had he been a tenant-at-will. Moreover, since the note was a standing note which required no amortization payments, Mayerson had no equity buildup from repayment of principal to defend or subject to risk of loss.

The Tax Court held for Mayerson, even though it accepted that "depreciation is not predicated upon ownership of property but rather upon an investment in property" and that "the benefit of the depreciation deduction should inure to those who suffer an economic loss caused by wear and exhaustion of the business property."[15] The court did not make clear how the initial sale put Mayerson in the position of one who would "suffer an economic loss" by immediate actual depreciation of the structure, but stressed that both parties intended a sale, not a lease, and that Mayerson expended substantial sums on repairs and improvements in the years immediately following the closing. Mayerson's "investment" in the property included the "valid debt obligation" created by the purchase-money note. The court said that in light of the frequency of non-recourse financing of real estate, and in light of the Supreme Court's decision in *Crane v. Commissioner*,[16] the lack of personal liability would not prevent the note obligation from being included in basis.[17] Nor would the fact that no principal was required to be repaid for ninety-nine years change the result. Although the ninety-nine year term did "seem unusually long," mortgagees frequently "waive payments of principal on income-producing properties in distress or incentive situations."[18] Moreover, the court sustained depreciation deductions that had been claimed on the full face amount of the note, despite the note's provisions for substantial discounts on early repayment and despite the fact that the note had been retired at a discount of over a third of its face amount. The subsequently "negotiated" purchase price was treated

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[15]*Id.* at 350.

[16]331 U.S. 1 (1947). *Crane* established that relief from liabilities, including non-recourse liabilities, is treated as a distribution of cash in the context of a system that includes those liabilities in depreciable basis.

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> Taxpayers who are not personally liable for encumbrances on property should be allowed depreciation deductions affording competitive equality with taxpayers who are personally liable for encumbrances or taxpayers who own unencumbered property. The effect of such a policy is to give the taxpayer an advance credit for the amount of the mortgage. This appears to be reasonable since it can be assumed that a capital investment in the amount of the mortgage will eventually occur despite the absence of personal liability.

47 T.C. at 352.

[18]*Id.* at 346.

as a bonus discount for early repayment. The court concluded that "the cost basis at the time of purchase should be the nondiscount price."[19]

*David F. Bolger*[20] involved "a fairly typically structured tax shelter of industrial real estate" that was sustained over the objection of four dissenting judges.[21] The Service challenged ten different transactions arranged by Bolger in the same basic pattern.[22] First, a financing corporation would be formed with an initial capitalization of $1,000, the shareholders of which were the investors who would ultimately receive title to the property and claim deductions as owners of depreciable interests. The corporation would then purchase a building that a commercial concern was prepared to lease immediately. On occasion, the seller of the building would become the lessee. Then, typically on the same day as the building purchase, the corporation would sell its own negotiable interest-bearing notes for the full amount of the purchase price to an institutional lender pursuant to a note purchase agreement that secured the notes by a first mortgage and by an assignment of the lease, the term of which was equal to or greater than the maturity of the note.[23] The corporation would then transfer the property to its investor-shareholders subject to both the long-term lease and the financing on which none of the investors assumed any personal liability.[24]

The commercial tenants occupied the premises under "net" leases with fixed annual rent.[25] However, the rental payments were only slightly more than the amount required to pay the debt service due on the mortgage. Under the provisions of the mortgage and lease assignment, the lessees were obligated to pay the rent directly to the mortgagee, who would distribute any excess over

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[19]*Id.* at 354.

[20]59 T.C. 760 (1973). An excellent discussion of this case is Lurie, *Bolger's Building: The Tax Shelter That Wore No Clothes*, 28 Tax L. Rev. 355 (1973).

[21]Weinstein, *The* Bolger *Case Is a Warning to Tax-Shelter Investors*, 2 Real Estate L.J. 595 (1973).

[22]Neither the Service nor the taxpayer sought separate treatment for the individual transactions.

[23]The financing corporation was also obligated to pay all the lender's out-of-pocket expenses, including legal fees.

[24]The documentation included an "assumption agreement" under which the transferee-investors were required to assume all the obligations of the corporation under the lease and mortgage. The agreement provided, however, that the transferees incurred no personal liability by reason of the assumption. In short, they "assumed" nothing.

[25]The leases provided that the lessees would pay all operating expenses, including taxes, insurance, and repairs. Thus, the rent paid to the lessor was "net" to him.

debt service to the corporation.[26] Finally, the lessee's rental obligation was to continue even if the building were destroyed, but in that event the lessee had the further right to purchase the building for an amount approximately equal to the sum required to repay the mortgage financing.[27]

In short, the "lessees" looked more like the mortgagor-owners of the property than did Bolger and his fellow transferees, although the latter claimed the interest and depreciation deductions as mortgagor-owners. The assignments of the leases to the lenders obligated the tenants to pay directly to the lenders the full amount of debt service on the purchase money loans, whereas the investors had no personal liability on those obligations. The personal liability of the commercial and manufacturing lessees was critical to the lender's security for repayment, and the liability of those claiming depreciation was nonexistent. Because the rents were fixed, the lessee retained all the benefits of increases in the operating income of the property. On the other hand, the investors were to receive only whatever nominal amounts were left over after the lessees' fixed rent payments were paid to and applied by the lender. The economic benefit the investors would receive would be in the buildup of equity in the property which would come under their control (a) at the expiration of the primary lease, which was typically twenty-five to twenty-eight years; or (b) at the expiration of the renewal options exercisable by the lessee, which were typically for three to five successive five-year terms at reduced rent. In short, control of the properties was not likely to come into the hands of the investors for some time, although there was a possibility of sharing in refinancing proceeds.

The Service, however, did not argue that the lessees were the ones entitled to the depreciation deductions. Rather, it argued that the depreciable interest vested in the corporation and did not pass to Bolger and the other transferees. The argument for denying Bolger the benefit of the deductions was that

> because of the long-term leases and the commitments of the rentals to the payment of the mortgages by virtue of the assignments of the leases which were consummated prior to the execution of deeds, the conveyances by each

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[26]The corporation was required to remain in existence and to refrain from engaging in any other activity.

[27]Refusal to accept the offer of purchase would terminate the lease. The lessee was permitted to sublease the premises or any portion thereof, and he was permitted to assign his interest in the lease, provided that the sublessee or assignee promised to comply with the terms of the mortgage and the lease, and further provided that the lessee remain personally liable for the performance of all its obligations under the lease.

> corporation transferred only a reversionary interest in the buildings and that consequently petitioner did not acquire a present interest in the properties which may be depreciated for income tax purposes.[28]

The Tax Court accordingly defined the two basic issues as (1) whether the corporation or its stockholder-transferee-investors should be treated as entitled to a depreciable interest and (2) whether, if the transferees were the holders of a depreciable interest, their bases in that interest included the amount of financing. The Tax Court found that the depreciable interest was held by Bolger and his fellow investors and concluded that, under the interpretation of *Crane* enunciated in *Mayerson,* the investors could include the amount of liabilities in their depreciable bases.

## IV. The Limited Partnership

In part because of its defeats in challenges to the underlying transaction in cases like *Mayerson* and *Bolger,* the Service has launched a series of attacks against the vehicle most commonly used to deliver surplus losses to high-bracket investors: the partnership and, in particular, the limited partnership. There is a greater likelihood that the Service will be more successful in such litigation because partnership tax doctrine is relatively undeveloped and was not designed to deal with current realty shelters. Subchapter K was drafted with the "ma-and-pa" grocery store more in mind than anything resembling publicly syndicated partnerships, offered and sold with computer printouts of depreciation and amortization schedules demonstrating post-tax return on investment to participants in different income brackets. The Regulations provide little additional guidance, and judicial development of some of the major provisions of Subchapter K has just begun. Given that the Service is relatively unfettered by established partnership doctrine, the limited partnership in particular stands ripe for attack for the very reason that it is so much more popular than the general partnership—it offers investors a pass-through of losses while providing a freedom from personal liability that appears extremely corporate.

The "corporateness" of the limited partnership form becomes even more clear from an historical perspective. Limited partnership acts in this country[29] antedated general corporation acts by

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[28] 59 T.C. at 768 (footnote omitted).

[29] Limited partnerships, which were also originally referred to in this country as "special partnerships," were not an American invention:

> In the French law, partnerships are distinguished into three sorts. * * * (2.) Partnerships *in commandité,* or *in commendam,* that is, limited partnerships, where the contract is between one or more

several decades.[30] At a time in which corporate charters were difficult to obtain, creditors who wanted more than a fixed rate of interest on their investment, or more "interest" than usury laws would permit, were subject to the risk of judicial imposition of personal liability as "partners" based on profit sharing. The solution was found in the early limited partnerships acts, which provided in short, that if one were really an outside creditor, and if that fact were made clear to the world at large, he could share in profits free from personal liability. Thus, a passive investor who followed the statutory procedure for informing the world of the nature and extent of his limited interest would be free from the personal liability of a partner. The early acts were strictly construed by the courts, which imposed full liability for minor failures in compliance. The Uniform Limited Partnership Act now provides that personal liability will not be imposed because of technical deviations from statutory requirements[31] and continues the themes of passive investment and formal notice to the world.[32]

### A. *Formation and Notice to the World*

Unlike a general partnership, a limited partnership will not spring into existence as a matter of law. Under the Act a limited partnership "is formed if there has been substantial compliance in good faith" with the Act's filing requirements.[33] Section 2 requires that a certificate of limited partnership be filed containing

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> persons, who are general partners, and jointly and severally responsible, and one or more other persons, who merely furnish a particular fund or capital stock, and thence are called *commandataire*, or *commendataires*, or partners *in commandité;* the business being carried on under the social name, or firm of the general partners only, composed of the names of the general or complementary partners, the partner *in commandité* being liable to losses only to the extent of the funds or capital furnished by them. * * * Similar distinctions are adopted in many other foreign countries, and in the Laws of Louisiana. Special partnerships *in commandité* have also been recently introduced into the jurisprudence of several States in the Union. But the regulations applicable to such partnerships vary in different countries and States, and are strictly local, and therefore seem unnecessary to be brought further under examination in the present Commentaries.

J. STORY, COMMENTARIES ON THE LAW OF PARTNERSHIP 127-28 (6th ed. 1868) (citations omitted).

[30]*See generally* A. BROMBERG, PARTNERSHIP § 26, at 143-44 (1968).

[31]UNIFORM LIMITED PARTNERSHIP ACT § 11 [hereinafter cited as ULPA].

[32]ULPA §§ 10, 6.

[33]ULPA § 2(2).

certain specified information.[34] In essence, the certificate must identify the general and limited partners and detail the nature and extent of the interests of the limited partners and the extent to which new limited partners may be admitted. Thus, for example, the certificate must state how much, when, and under what circumstances the limited partners must contribute, the share of profits or other compensation by way of income that each limited partner will receive by way of his contribution, and any limited partner's right to demand property other than cash in return for his contribution. A major inconvenience of the limited partnership form is that the certificate must be amended to reflect changes in the required information. The partnership agreement should be drafted to remind the client that improper or misleading notice to the world, either as a result of omissions or false statements in the certificate,[35] or by improper use of the surname of a limited partner in the partnership name,[36] can result in the loss of limited liability.

### B. *The Limited Partner as Passive Investor*

A limited partner may contribute cash or other property, but not services, for his interest in the partnership.[37] Although limited partners "*as such* shall not be bound by obligations of the partnership,"[38] a limited partner may lose his limited liability if he takes part in the "control" of the business.[39] A disadvantage of the limited partnership form is uncertainty about what constitutes "control" within the meaning of the Act. The statute does not say that a limited partner who exercises control will automatically lose his limited liability. It simply provides that he *may* lose it. In short, the wording of the Act does not require strict application of the "control" provision, and courts may take into account considerations of third party reliance in determining whether to deny limited liability to a limited partner who has arguably exercised control.[40]

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[34]Under the ULPA as enacted in some jurisdictions, a certificate must be filed in more than one place. *See, e.g.*, CONN. GEN. STAT. ANN. § 34-10(1)(b) (Supp. 1975); NEV. REV. STAT. § 88.030(1)(b) (1973).

[35]ULPA § 6.

[36]ULPA § 5.

[37]ULPA § 4.

[38]ULPA § 1 (emphasis added).

[39]"A limited partner *shall not become liable* as a general partner *unless*, in addition to the exercise of his rights and powers as a limited partner, *he takes part in the control* of the business." ULPA § 7 (emphasis added).

[40]*See* Feld, *The "Control" Test for Limited Partnerships*, 82 HARV. L. REV. 1471 (1969).

The peculiar nature of limited partnerships under local law continues to present questions under the Code, which has no separate limited partnership classification. In *Meyer v. Commissioner*,[41] it was recently held that an exchange of a general partnership interest for a limited partnership interest was not an exchange of like-kind properties, even though both partnerships owned and rented apartments in the same area:

> A general partner has a broad spectrum of rights and liabilities while a limited partner is largely shielded from liability and his rights are generally limited to a right to inspect the partnership books, to an accounting, to have the partnership dissolved in certain situations and, under certain circumstances, to withdraw his contribution to the partnership. . . . He may not actively participate in running the business and his liability is generally limited to the amount of his investment.[42]

In conclusion, insofar as limited partnerships were originally created to avoid the common law of partnership liability when the corporate form was not readily available, insofar as the nature of a limited partner's rights and liabilities is "of a different nature and character" from those of a general partner, and insofar as the principal advantage of the limited partnership form after the enactment of general corporation acts lies in its treatment as a partnership for tax purposes, it is not surprising that the Service has suggested that certain limited partnerships be classified as corporations for tax purposes.

## V. Federal Income Tax Classification

### A. *Unreliability of the Regulations*

Two points should be emphasized at the outset of a discussion of the classification Regulations. First, under the Regulations, an organization may be taxed as a corporation even if it is a partnership under local law. Federal law determines the standards for tax classification, while local law determines whether the federal standards are met.[43] Second, the Regulations cannot currently be viewed as completely controlling with respect to tax classification. An organization may qualify as a partnership under the Regulations and still have no assurance that it will be so classified for tax purposes. The Service would prefer to withhold partnership

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[41]503 F.2d 556 (9th Cir.), *aff'g per curiam* 58 T.C. 311 (1974).

[42]503 F.2d at 557-58 (citations omitted).

[43]Treas Reg. § 301.7701-1(c) (1965).

classification from limited partnerships that appear extremely corporate and is attempting to work around the present classification Regulations, which are heavily biased toward partnership classification of all partnerships, general or limited, under Uniform Acts.[44] The Regulations, originally based on the opinion in *Morrissey v. Commissioner*,[45] were amended in an attempt by the Treasury to make it extremely difficult for professional associations to achieve corporate classification. The battle with the professional associations is over, but the Service is saddled with Regulations extremely biased toward partnership classification.[46] A brief review of the Regulations will reveal the bias and highlight the significance of the Service's recent actions.

### B. *The Regulations*

The Code definition of a "partnership" is a negative one,[47] embracing groups that are not, for tax purposes, trusts, estates,

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[44]A few states authorize a form of organization known as a "partnership association" or a "limited partnership association." Prior to the adoption of the current classification Regulations, the Regulations provided that such organizations were taxable as corporations. Treas. Reg. § 39.3797-6 (1955). The current Regulations treat partnership associations in the section captioned "Partnerships" and do not flatly state that they are taxable as corporations, but merely provide that they, like other organizations, must run the "corporate characteristics" gamut to determine their classification. Treas Reg. § 301.7701-3(c) (1960). In Rev. Rul. 71-434, 1971-2 CUM. BULL. 430, the Service applied the "corporate characteristics" test to an organization formed as a partnership association under Ohio law and concluded that the organization was taxable as a corporation.

[45]296 U.S. 344 (1935). In *Morrissey*, the Court found a "trust" to be an association taxable as a corporation.

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> Clarity on the corporate-noncorporate characterization has not been promoted by the curious but economically understandable role reversal which has occurred. In the 1920-30s the tax authorities were seeking corporate treatment of many unincorporated organizations which resisted it. In the 1950-60s the tax authorities were resisting corporate treatment of many unincorporated organizations which sought it. In each period, of course, it was a matter of which form produced higher taxes for the organizations involved.

A. BROMBERG, PARTNERSHIP § 24, at 140 (1968).

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> The term *"partnership" includes* a syndicate, *group*, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and *which is not*, within the meaning of this title, *a trust or estate or a corporation;* and the term "partner" includes a member in such a syndicate, group, pool, joint venture, or organization.

CODE § 7701(a)(2) (emphasis added). *See also* CODE § 761(a), (b).

or corporations.[48] Under the Regulations, "corporate characteristics" are the basis for distinguishing a partnership from an association taxable as a corporation. Six "major characteristics" ordinarily found "in a pure corporation" tend to distinguish the corporate form from other organization forms. These corporate characteristics include (1) associates; (2) an objective to carry on business and divide the gains therefrom; (3) coninuity of life; (4) centralization of management; (5) liability for corporate debts limited to corporate property; and (6) free transferability of interests. Because the first two characteristics are "generally common to both corporations and partnerships," tax classification depends on the presence of the last four.[49] Furthermore, the Regulations provide that an unincorporated organization will "not be classified as an association unless such organization has more corporate characteristics than noncorporate characteristics."[50] The basic rule is that partnership classification is available whenever any two of the last four corporate characteristics are avoided. Although the Regulations state that "other factors" in addition to these "may be found in some cases which may be significant in classifying an organization as an association, a partnership, or a trust," there is no suggestion as to what those "other factors" might be.[51]

### *1. Centralization of Management*

Centralized management is present if any person or group "has continuing exclusive authority to make the management decisions necessary to the conduct of the business" such that the persons "resemble the directors of a statutory corporation."[52] Those having the authority need not be members of the organization,[53] but must have

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[48]"Corporation" is broadly defined to include "associations, joint-stock companies and insurance companies." CODE § 7701(a)(3). See also Treas. Reg. § 301.7701-(c) (1965), which provides:

> The term "corporation" is not limited to the artificial entity usually know as a corporation, but includes also an association, a trust classed as an association because of its nature or its activities, a joint-stock company, and an insurance company.

[49]Treas. Reg. § 301.7701-2(a)(2) (1965).

[50]*Id.* § 301.7701-2(a)(3).

[51]*Id.* § 301.7701-2(a)(1).

[52]*Id.* § 301.7701-2(c)(1). The Regulations further provide that organizations "composed of many members" generally are centrally managed.

[53]*Id.* § 301.7701-2(c)(2):

> Centralized management can be accomplished by election to office, by proxy appointment, or by any other means which has the effect of concentrating in a management group continuing exclusive authority to make management decisions.

> continuing *exclusive* authority to make independent business decisions on behalf of the organization which do not require ratification by members of such organization. Thus, there is not centralized management when the centralized authority is merely to perform ministerial acts as an agent at the direction of a principal.[54]

Exclusivity of management authority is flatly deemed absent in general partnerships because of the "mutual agency relationship" among general partners. An agreement among the partners to vest management powers exclusively in a select few "will be ineffective as against an outsider who had no notice of it" and is insufficient to constitute centralized management.

Even though limited partners may not exercise "control" over the business, limited partnerships generally do not have centralized management. However, "centralized management ordinarily does exist in such a limited partnership if *substantially* all the *interests* in the partnership are owned by the limited partners."[55] It is not clear what "interests" are significant, for example, in net cash flow, capital, or taxable income or loss. Nor is there any indication in the Regulations when "substantially all" the interests are owned by the limited partners, although there appears to be some informal understanding that centralized management is eliminated when the general partners own at least twenty percent of all the interests in the partnership.[56]

### 2. *Limited Liability*

Limited liability is present "if under local law there is no member who is personally liable for the debts of or claims against the organization."[57] Personal liability exists with respect to each general partner in a general partnership. Similarly, personal liability exists with respect to each general partner in a limited partnership except

> with respect to a general partner when he has no substantial assets (other than his interest in the partnership) which could be reached by a creditor of the organization

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[54] *Id.* § 301.7701-2(c)(3) (emphasis added).

[55] *Id.* § 301.7701-2(c)(4) (emphasis added).

[56] Sexton, *Qualifying as a Partnership for Tax Purposes*, 1974-2 N.Y.U. 32D INST. ON FED. TAX. 1447, 1459.

[57] Treas. Reg. § 301.7701-2(d)(1) (1965). Even if a person who is personally liable for the obligations of the organization is the beneficiary of an indemnification agreement, personal liability still exists with respect to that member if the member remains personally liable to creditors. *Id.* This is true whether or not the indemnifying party is a member of the organization.

> *and when* he is merely a "dummy" acting as the agent of the limited partners.[58]

The general partner must have no substantial assets *and also* must be merely a "dummy" before the corporate characteristic of limited liability will be present. Limited liability may not even be deemed to exist with respect to a corporate general partner with insubstantial assets. Personal liability exists with respect to a corporate general partner

> when the corporation has substantial assets (other than its interest in the partnership) which could be reached by a creditor of the limited partnership. . . . In addition, although the general partner has no substantial assets (other than his interest in the partnership), personal liability exists with respect to such general partner when he is not merely a "dummy" acting as the agent of the limited partners.[59]

It would seem impossible for a limited partnership to have the corporate characteristic of limited liability because there will be personal liability as to general partners who are not "dummies," whether they have substantial assets or not; if they are "dummies," personal liability will exist with respect to the limited partners for whom they act.[60]

### *3. Free Transferability of Interests*

Free transferability of interests is present if each of the members of the organization "or those members owning substantially all of the interests in the organization have the power, without the consent of other members, to substitute for themselves in the same organization a person who is not a member of the organization."[61]

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[58] *Id.* § 301.7701-2(d)(2) (emphasis added).

[59] *Id.* As to what constitutes "substantial assets," the Regulations state:

> [I]f the organization is engaged in financial transactions which involve large sums of money, and if the general partners have substantial assets (other than their interests in the partnership), there exists personal liability although the assets of such general partners would be insufficient to satisfy any substantial portion of the obligations of the organization.

*Id.*

[60]

> Notwithstanding the formation of the organization as a limited partnership, when the limited partners act as the principals of such general partner, personal liability will exist with respect to such limited partners.

*Id.*

[61] *Id.* § 301.7701-2(e)(2). If the right to substitute is subject to a right of first refusal in the other members,

> it will be recognized that a modified form of free transferability of

The member must be able to transfer, without consent, "all the attributes of his interest in the organization."[62] Free transferability does not exist when a member can assign his right to share in profits "but cannot so assign his right to participate in the management of the organization."[63] Furthermore, even though the agreement provides for the transfer of a member's interest, "there is no power of substitution and no free transferability of interest if under local law a transfer of a member's interest results in the dissolution of the old organization and the formation of a new organization."[64]

The corporate characteristic of free transferability can be eliminated in a wide variety of situations at little or no cost. Because of the "control" limitation, limited partners generally have very little right to participate in management and are generally only entitled to an accounting and the right to inspect and copy the partnership books. Therefore, little, if anything, is lost to the transferee who does not become the full substitute of a limited partner. Further, restrictions on transfer may be necessary for reasons apart from the classification Regulations—for example, to assure continued availability of a private placement or intrastate exemption to the state or federal security laws, and to avoid automatic termination for tax purposes.

### *4. Continuity of Life*

An organization has continuity of life "if the death, insanity, bankruptcy, retirement, resignation, or expulsion of any member will not cause a dissolution of the organization."[65] Dissolution is defined as "an alteration of the identity of an organization by reason of a change in the relationship between its members as determined under local law."[66] Thus, dissolution is defined as a mere technical reconstitution of the organization under local law so that, theoretically, a new organization continues the business. Termination of the business is not required to eliminate continuity

> interests exists. In determining the classification of an organization, the presence of this modified corporate characteristic will be accorded less significance than if such characteristic were present in an unmodified form.

*Id.* How much "less significance" will be accorded is not clear.

[62] *Id.* § 301.7701-2(e) (1).

[63] *Id.* Under the ULPA, a limited partner may not assign all his interest unless given a right to do so in the certificate or unless all the members consent. ULPA § 19. Therefore, he may assign only his interest in profits and losses and not his interest in management.

[64] Treas. Reg. § 301.7701-2(e)(1) (1965).

[65] *Id.* § 301.7701-2(b)(1).

[66] *Id.* § 301.7701-2(b)(2).

of life, which may be eliminated even though the business may be continued indefinitely.[67] Even contractual obligations to continue the organization by the remaining members upon the death or withdrawal of any member will not result in continuity of life if, notwithstanding such agreement, the organization is dissolved under local law. Furthermore, notwithstanding an agreement to continue the organization for a stated period or until the completion of a stated transaction, if any member has the power under local law to dissolve the organization, continuity of life is eliminated. Therefore, partnerships corresponding to either of the Uniform Acts lack continuity of life.[68]

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[67]This is so even though ULPA § 20 provides:

> The retirement, death or insanity of a general partner dissolves the partnership, unless the business is continued by the remaining general partners
>
> (a) Under a right so to do stated in the certificate, or
>
> (b) With the consent of all members.

[68]Treas. Reg. § 301.7701-2(b)(3) (1965). The Service took the position that the California Limited Partnership Act, CAL. CORP. CODE §§ 15,501 *et seq.* (West 1955), as amended in 1963, *id.* § 15,520 (West Cum. Supp. 1975), no longer corresponded to the ULPA, such that a California limited partnership necessarily had the corporate characteristic of continuity of life. Such a conclusion is critical to public limited partnerships, which normally have the corporate characteristics of centralization of management and free transferability of interests, and which will be taxed as corporations if they are deemed to have either of the two remaining corporate characteristics—limited liability and continuity of life. The thrust of the California amendments was to further a policy of investor democracy by mandating the right of limited partners to vote on certain matters affecting the basic structure of the limited partnership, such as the sale of all or substantially all the partnership assets and the election or removal of general partners. As a result of the uncertainty caused by the Service's position, the California legislature, effective November 1, 1973, re-amended the California Act so that the continuity of life provision is again identical with the ULPA provision. *Id.* § 15,520.5.

Notwithstanding the amendment to the California statute, the California Commissioner of Corporations has stated that he will continue to require provisions in the limited partnership agreement authorizing a vote of the limited partners to remove a general partner and accept a new general partner.

> With the 1973 amendment to the California Uniform Limited Partnership Act, the withdrawal of the general partner who is voted out will cause the dissolution of the organization, and there is no provision in the statute providing for continuity in that case. Thus, under the existing Regulations, continuity of life will not exist in a California limited partnership even if there is a provision in the partnership agreement for continuing the partnership where a general partner is voted out and a new general partner is voted in.

Sexton, *supra* note 56, at 1468.

On June 11, 1974, the Service ruled that the amended California Limited Partnership Act, which provides for dissolution of a partnership upon the retirement, death or insanity of a general partner, is a statute cor-

### *C. Revenue Procedure 72-13 and Beyond*

In short, the Regulations are so biased in favor of partnership classification that draftsmen developed quick rules of thumb to eliminate at least two corporate characteristics to secure partnership classification. Into this rather pleasant world for limited partnerships, the Service dropped the bombshell of Revenue Procedure 72-13.[69] This procedure purports to do nothing more than state the conditions that must be met to obtain an advance ruling on the tax classification of a limited partnership whose sole general partner is a corporation.[70] Nevertheless, many practitioners have been compelled to treat the requirements of 72-13 as substantive and binding, not merely procedural. First, as a practical matter, some transactions would not be consummated without an advance ruling. Second, agents began to apply the 72-13 quidelines as substantive requirements on audit.[71] Third, some state securities agencies have begun to insist that the requirements of 72-13 be met on the ground that an offering is not sufficiently "fair, just and equitable" if the critical element of a partnership tax classification is unestablished. Finally, many practitioners are painfully aware that a limited partnership with a sole corporate general partner is functionally indistinguishable from a corporation apart from tax considerations. The basic objection to the 72-13 requirements is not that partnership classification is ultimately appropriate, but that the requirements are inconsistent with the Regulations and somewhat arbitrary. The three requirements are those of stock ownership, investment unit, and net worth.

#### *1. Stock Ownership*

The requirement that the "limited partners will not own, directly or indirectly, individually or in the aggregate, more than 20 percent of the stock of the corporate general partner or any affiliates"[72] is arguably relevant to the corporate characteristic

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responding to the Uniform Limited Partnership Act. Thus, an association formed under the California Act as amended would lack the corporate characteristic of continuity of life. Rev. Rul. 74-320, 1974-2 CUM. BULL. 404-05. The ruling emphasizes that the Regulations require only a very technical kind of dissolution to eliminate continuity of life.

[69]Rev. Proc. 72-13, 1972-1 CUM. BULL. 735.

[70]The requirements of Revenue Procedure 72-13 are applied in any situation in which a limited partnership has no individual general partner.

[71]Welter, *Limited Partnerships With A Corporate General Partner—Rev. Proc. 72-13*, 5 TAX ADVISOR 329 (1972).

[72]Rev. Proc. 72-13, 1972-1 CUM. BULL. 735. For the purpose of determining stock ownership in the corporate general partner or its affiliates, the attribution rules of CODE § 318 apply.

of the Regulations.[73] If the limited partners own enough stock in the corporate general partner to control it, centralized management analogous to that placed in a corporate board of directors may be present. Continuity of life may be present if the limited partners can prevent the corporate general partner from dissolving or withdrawing from the partnership. Free transferability of interests is arguably present if the limited partners can force the general partner to approve transfers of interests. An attempt at limited liability is present if the corporate general partner is merely an agent controlled by the limited partners.[74] Consider the most clear-cut example of a corporate general partner wholly owned by the limited partners in proportion to their partnership interests. Avoidance of corporate tax and entitlement to pass-through of losses would be sought, in effect, by the device of dubbing the stockholders limited partners.

In part because the stock ownership requirement is fairly arguably related to the corporate characteristics in the classification Regulations, criticism has centered not so much on the fact that a stock ownership requirement is imposed as on the twenty percent figure. Some feel that the twenty percent limit on ownership of the stock of the general partner is too strict because the holders of only twenty percent of the stock of a corporation rarely control it, even though effective control is often present in the absence of absolute control.

### 2. *Investment Unit*

The requirement that the purchase of a limited partnership interest "does not entail a mandatory or discretionary purchase or option to purchase any type of security of the corporate general partner or its affiliates" is somewhat more elusive. The rationale appears to be that such a coupling makes it difficult for the Service to determine exactly what is being purchased. The prin-

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[73]This requirement seems to assume a corporate general partner with only one class of stock.

[74]However, it is hard to imagine when there could be limited liability under the Regulations since they state there would be personal liability as to the limited partners who "control" a general partner. See text accompanying notes 37-40 *supra*. There is, however, one basic possibility that suggests itself. Under the Regulations, the personal liability of the limited partners in such a situation is based on local law. If, under local law, a reliance requirement were imposed before limited partners would lose their limited liability because of "control," then there might not always be personal liability resulting from an exercise of control. Consider, for example, the situation in which a limited partnership's asset is subject to a long-term net lease to a management company. The ability of the limited partners to control the relatively minor functions that might be undertaken by the general partner might be insufficient to support an imposition of personal liability on them.

cipal criticism of this requirement centers on the lack of its correlation with the twenty percent stock ownership limitation, insofar as the coupling of any purchase of any security of the corporate general partner with the purchase of a limited partnership interest is sufficient to preclude a favorable ruling. In any event, the investment unit requirement is not that controversial because the problem generally is easy to avoid.

### *3. Net Worth*

The net worth requirement has caused the greatest controversy:

> If the corporate general partner has an interest in only one limited partnership and the total contributions to that partnership are less than $2,500,000 the net worth of the corporate general partner at all times will be at least 15 percent of such total contributions or $250,000, whichever is the lesser; if the total contributions to that partnership are $2,500,000 or more, the net worth of the corporate general partner at all times will be at least 10 percent of such total contributions.[75]

Although objections have been made that these requirements are inherently vague[76] and arbitrary,[77] the fundamental objection is that they are in direct conflict with the Regulations.

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[75]Rev. Proc. 72-13, 1972-1 CUM. BULL. 735.

[76]The vagueness objection focuses on the uncertainty in computing the two central figures to the net worth requirement—total contributions to the partnership and the net worth of the corporate general partner. Revenue Procedure 72-13 does not elaborate on the computation of "total contributions" to the limited partnership. The Service apparently will exclude from the scope of the term "contributions" the value of services rendered or to be rendered by a general partner and loans made to the partnership. Weiler, *Limited Partnerships with Corporate General Partners: Beyond Rev. Proc. 72-13,* 36 J. TAXATION 306 (1972). As to the question of loans, debt-equity distinctions, although developed primarily in the corporate context, apply also to partnerships. Joseph W. Hambuechen, 43 T.C. 90 (1964). If a "loan" were treated as a contribution to capital for basis purposes, it would presumably be similarly treated in computing "total contributions" under Revenue Procedure 72-13. *See generally* Rev. Rul. 72-135, 1972-1 CUM. BULL. 200; Rev. Rul. 72-350, 1972-2 CUM. BULL. 394. It is also unclear whether the general partner must, from the outset, maintain its net worth in relation to the total contributions as they are made or to the total expected contributions. The contributions of the limited partners in real estate partnerships are frequently made on a staggered basis, like construction loans. It is not clear whether the general partner can satisfy Revenue Procedure 72-13 by maintaining the required percentage of contributions at any given point and increasing its net worth as contributions increase.

[77]When the corporate general partner has an interest in only one limited partnership, the partner's net worth does not include its interest in the

The net worth requirements bear directly on the corporate characteristic of limited liability. The Regulations state that when a corporation is the general partner personal liability exists as to the corporation if it has substantial assets other than its interest in the partnership. However, the Regulations further provide that the corporate characteristic of limited liability will not be present, even if the general partner has insubstantial assets, so long as the general partner is not merely a "dummy" acting as agent for the other partners.[78] The net worth requirement of 72-13 effectively eliminates the latter provision in the Regulations, at least insofar as it is being applied as a substantive requirement by agents on audit and state securities commissioners. To that extent, 72-13 does more than increase the difficulty of avoiding the corporate characteristic of limited liability. It is tantamount to a requirement that the corporate characteristic of limited liability must be in eliminated, and, as such, it is not in accord with the equal weight given each characteristic under the Regulations.

More recent actions by the Service have converted the uncertainty caused by Revenue Procedure 72-13 into fear of an all-out

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limited partnership or any accounts or notes receivable from or payable to the limited partnership. If the corporate general partner has interests in more than one limited partnership, Revenue Procedure 72-13 seems to require that its net worth be computed without reference to *any* of its interests in any limited partnership or to any accounts or notes receivable from or payable to any limited partnership:

> If the corporate general partner has interests in more than one limited partnership, the net worth requirements explained in the preceding paragraph will be applied separately for each limited partnership, and the corporate general partner will have at all times (exclusive of any interest in any limited partnership and notes and accounts receivable from and payable to any limited partnership in which the corporate general partner has any interest), a net worth at least as great as the sum of the amounts required . . . for each separate limited partnership.

Rev. Proc. 72-13, 1972-1 CUM. BULL. 735. This latter rule has been criticized as an arbitrary exclusion of valuable assets of the general partner, particularly insofar as it eliminates from the computation assets in the form of limited partnership interests in limited partnerships in which the corporation is not a general partner.

Revenue Procedure 72-13 also requires that a corporation, when it is the sole general partner of more than one limited partnership, must maintain at all times a net worth as great as the sum of the amounts required with respect to each limited partnership. This rule has been criticized as encouraging the formation of a single, large, limited partnership in order to bring the ten percent figure into operation, since several small limited partnerships would each be required to meet the fifteen percent requirement which applies when total contributions are less than $2,500,000.

[78]See the discussion of the corporate characteristic of limited liability in text accompanying notes 57-60 *supra*.

war on realty shelter partnerships. In Revenue Procedure 74-17, the Service announced "certain conditions" under which it would not issue advance rulings "concerning classification of organizations which raise factual questions as to whether their 'principal purpose' is the reduction of Federal taxes."[79] Revenue Procedure 74-17 contains a direct disclaimer of a kind not included in Revenue Procedure 72-13:

> These operating rules do not define, as a matter of law, whether the principal purpose of the organization is the reduction of Federal taxes, nor whether participants in an organization are partners or whether such an organization is a partnership, nor do they define any other terms used in the Internal Revenue Code, Income Tax Regulations, Procedure and Administration Regulations, or Revenue Rulings.[80]

Nevertheless, the requirements clearly set out the kinds of factors that Commissioner Alexander had mentioned as susceptible to challenge.[81]

> .01 The interests of all of the general partners, taken together, in each material item of partnership income, gain, loss, deduction or credit is equal to at least one percent of each such item at all times during the existence of the partnership. In determining the general partners' interests in such items, limited partnership interests owned by the general partners shall not be taken into account.
>
> .02 The aggregate deductions to be claimed by the partners as their distributive shares of partnership losses for the first two years of operation of the limited partnership will not exceed the amount of equity capital invested in the limited partnership.
>
> .03 A creditor who makes a nonrecourse loan to the limited partnership must not have or acquire, at any time as a result of making the loan, any direct or indirect interest in the profits, capital, or property of the limited partnership other than as a secured creditor.[82]

In short, the Service has identified several characteristics of realty partnerships that may subject them to challenge under partnership doctrine and under more general principles of tax avoidance. Paragraph .01 is aimed at allocation systems, of the type discussed below, that produce dramatic separations of economic

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[79] Rev. Proc. 74-17, 1974-1 Cum. Bull. 438.

[80] *Id.* at 439.

[81] *See* 40 J. Taxation 37 (1974).

[82] Rev. Proc. 74-17, 1974-1 Cum. Bull. 438, 439.

benefits from tax benefits and raise questions about the existence of a partnership and about the "principal purpose" of partnership allocations. Paragraph .02 is a suggestion that a result-oriented approach may be applied to the "principal purpose" limitation on partnership allocations and can also be interpreted as raising fundamental issues about whether a partnership has been entered into for "profit." Paragraph .03 suggests that non-recourse "loans" made to the partnership by participants will be scrutinized more carefully to determine whether they may be used to increase basis or to support claims of guaranteed payments.

Early this year, the Service issued Revenue Procedure 75-16, a "checklist outlining required information that is frequently omitted from requests for rulings" on tax classification.[83] The information now required to obtain a classification ruling includes many items that, until recently, practitioners had not considered relevant to the issue of tax classification. The required information includes net worth representations as to all general partners, not merely corporate general partners, a detailed description of "creditors' interests" and "benefits," and a detailed description of the partnership's method of allocating profits and losses, including the economic significance, if any, of negative capital accounts. In effect, those seeking classification rulings must now disclose factors that will alert the Service to potential challenges to some or all of the partnership's characteristics and transactions on issues other than classification. In addition, it has recently been reported that the Service has taken the position on audit that the non-recourse nature of a major portion of a limited partnership's liabilities, coupled with a lack of substantial assets on the part of its corporate general partner, will cause a limited partnership to have the corporate characteristic of limited liability.[84] The net effect of these recent actions is that counsel must be much more cautious about relying on "the letter of the law" as it has been written until recently and more concerned about the economic realities of proposed partnership arrangements.

## VI. Partnership Allocations

Flexibility in allocating various economic and tax consequences of operations among partners has long been considered a prime advantage of the partnership form. Section 704 broadly states that a partner's share of income, gain, loss, deduction, or credit may be determined by the partnership agreement, except that allocations that are made for the "principal purpose" of

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[83]Rev. Proc. 75-16, 1975 Int. Rev. Bull. No. 10, at 59.

[84]*Point to Remember No. 1*, 28 Tax Law. 409 (1975).

the avoidance or evasion of tax shall be disregarded and reallocated according to the partner's ratio for sharing "taxable income or loss of the partnership, as described in section 702(a)(9)."[85] Thus, for example, a partner who undertakes to pay all partnership research and experimental expenditures may be allocated the deductions for the full amount of those expenditures, provided the allocation is not made for the principal purpose of tax avoidance or evasion.[86]

In the real estate area, a great deal of advantage has been taken of the ability to allocate items of deduction and loss, and the Service has recently refused to rule on whether the "principal purpose" limitation has been violated.[87] Partners, particularly in real estate partnerships, rarely have one, flat, over-all percentage interest. A partner may have several ratios for sharing different items of partnership income, gain, loss, deduction, or credit, and the ratios may change over time. The benefit of depreciation deductions, for example, is frequently allocated specially. Many real estate partnerships use three basic allocations to separately allocate cash benefits and surplus losses: (1) net cash flow; (2) taxable income or loss; and (3) proceeds in the event of refinancing or sale. These three allocations operate *concurrently*, not alternatively.

The following hypothetical demonstrates the use of a three-way allocation system to allocate to limited partners a greater share in tax losses than they have in cash benefits. A limited partnership is formed with general partner *G* and limited partners *A* and *B*. The partnership agreement provides that the net cash flow from the enterprise will be allocated 50% to *G* and 25% each to *A* and *B*. The partnership agreement also provides that the proceeds of any refinancing or sale will be allocated 60% to *G* and 20% each to *A* and *B*. The partnership agreement further provides that the taxable income or loss of the partnership will be allocated among the partners in proportion to their initial contributions to capital. *G* makes no initial contribution to capital and *A* and *B* each make an initial contribution to capital of $5,000. An apartment house is acquired for $100,000, paid for with the initial contributions to capital and the proceeds of a $90,000 non-recourse loan.

The partnership thus has three different allocation ratios, all or none of which could be brought into play in a particular year, depending on the results of partnership operations:

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[85]CODE § 704(b).

[86]Treas. Reg. § 1.704-1(b)(2), Example (5) (1964).

[87]Rev. Proc. 74-22, 1974-2 CUM. BULL. 476.

| | Net Cash Flow | Proceeds of Refinancing or Sale | Taxable Income or Loss |
|---|---|---|---|
| G | 50% | 60% | 0% |
| A | 25% | 20% | 50% |
| B | 25% | 20% | 50% |

Consider the effect of such an allocation system in a typical year in which there is a tax shelter in our second sense and in which there is no refinancing or sale of the property.[88] If rent receipts are $10,000, real estate taxes are $700, maintenance expenses are $300, debt amortization is $2,000, and interest paid on indebtedness is $6,000, the net cash flow from the operation of the property is $1,000. If the depreciation deduction in the same year is $12,000, the partnership has a $9,000 tax loss for the year computed as follows:

$$TI = NCF - \text{Depreciation} + \text{Debt Amortization}$$
$$TI = 1{,}000 - 12{,}000 + 2{,}000$$
$$TI = (9{,}000).$$

Under the hypothetical partnership agreement, the net cash flow will be allocated according to the 50-25-25 ratio specified in the partnership agreement and the tax loss will be reported by the partners according to the 0-50-50 ratio of their initial contributions to capital. In summary, as a result of the year's operation, the partners are allocated the following:

| | Shares of Net Cash Flow | Shares of Partnership Tax Losses |
|---|---|---|
| G | $500 | $ 0 loss deduction |
| A | 250 | 4,500 loss deduction |
| B | 250 | 4,500 loss deduction |

The attractiveness of this kind of arrangement to a promoter who wants to pass the bulk of tax losses to his investor-partners is clear. By allocating tax losses according to initial capital contributions, *G* has established a fixed ratio that passes to the limited partners the benefit of all depreciation and other deductions beyond those necessary to shelter from tax the net cash flow and debt amortization of the partnership. In an apparent desire to conceal the extreme separation of tax and economic consequences that three-way systems can effect, they are frequently drafted in ways that are extremely difficult for the uninitiated to decipher. For example, the "taxable income or loss" and "net cash flow" allocations may be carefully defined but never so labeled.

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[88]See section II *supra.*

It has never been decided whether allocations of "taxable income or loss" are subject to the "principal purpose" limitation of Code section 704(b)(2), and the Committee on Partnerships of the American Bar Association's Tax Section recommended last summer that Subchapter K be amended specifically to make allocations of "taxable income or loss" subject to the principal purpose limitation.[89] This suggestion would not necessarily accomplish anything, because it is not clear how the principal purpose limitation would be applied. One basic problem is that standards for the application of the principal purpose limitation have never been developed. The only decision that disregarded an allocation on the basis of section 704(b)(2) is *Stanley C. Orrisch*,[90] which involved such a clear-cut violation of section 704(b) that it offers little insight into the scope of the principal purpose limitation. *Orrisch* involved two husband and wife couples, the Orrisches and the Crisafis, who had been equal partners in the ownership of two apartment houses. In a year in which the Crisafis had substantial tax losses from other sources, they changed their agreement and allocated the Orrisches all the depreciation deductions of the partnership. The Orrisches' capital account was lowered by the amount of all the depreciation deductions allocated to them, with the result that their account was far below that of the Crisafis. The court found that the charges against the Orrisches' capital account had no economic significance. The shift in the allocation of depreciation deductions, although reflected as a charge against the Orrisches' capital account, had no effect on any of the non-tax arrangements of the parties, not even on the division of the proceeds from the sale of the partnership property. The basic test for determining whether the principal purpose of an allocation is for the avoidance or evasion of tax is whether it has "substantial economic effect and is not merely a device for reducing the taxes of certain partners without actually affecting their shares of partnership income . . . ."[91] Since the allocation of all the depreciation deductions to the Orrisches did not "actually affect the dollar amount of the partners' shares of the total partnership income or loss independently of tax consequences,"[92] it was disregarded and reallocated according to "taxable income or loss, as described in section 702(a)(9),"

[89] ABA Committee on Partnerships, *Report of the Committee on Partnerships, Tax Section Recommendation No. 1974-5*, 27 TAX LAW. 839, 847 (1974).

[90] 55 T.C. 395 (1970), *aff'd per curiam* P-H 1973 FED. TAXES ¶ 28, 566 (31 Am. Fed. Tax R.2d ¶ 73-556, at 73-1069) (9th Cir., Mar. 30, 1973).

[91] S. REP. No. 1622, 83d Cong., 2d Sess. 379 (1954).

[92] Treas. Reg. § 1.704-1(b)(2) (1964).

that is, according to the parties' 50-50 ratio for sharing the general profits or losses.

Allocations of "taxable income or loss" are often difficult to attack under the principal purpose limitation. Care has usually been taken to relate the allocation of taxable income or loss to some economic aspect of the partnership, such as initial contribution to capital. Furthermore, it is difficult to determine how an allocation of taxable income or loss in a partnership agreement should be reallocated in the event it is disregarded. Section 704(b) provides that if an allocation does not pass muster under the principal purpose limitation, it will be disregarded and reallocated according to the partners' ratio for sharing "taxable income or loss of the partnership, as described in section 702(a)(9)." This presented no difficulty in *Orrisch* because the parties had one, flat, 50-50 ratio for sharing everything but depreciation deductions. However, consider the conundrum presented an eager tax collector who would like to disregard an allocation of "taxable income or loss" and is faced with the rule that disregarded allocations are to be reallocated in accordance with "taxable income or loss." The answer, in short, to the difficulty in applying this reallocation mechanism is that "taxable income or loss, as described in section 702(a)(9)" was intended to be the partners' ratio for sharing the overall profits and losses of the enterprise. Therefore, if it is decided that the partners' allocation of taxable income or loss should be disregarded because it controls tax losses and nothing more and is for the principal purpose of avoidance or evasion of tax, the losses should be reallocated according to the ratios that control the partners' shares in the economic consequences of the enterprise. Note that this could be the ratio for sharing net cash flow, the ratio for sharing proceeds of refinancing or sale, or a combination of both. For safety's sake, allocations of taxable income or loss should be given some economic significance other than their relation to initial contribution to capital. The *Orrisch* court rejected the petitioners' argument that they could be specially allocated all the depreciation because they had contributed more money to the partnership than their partners and would continue to do so. Therefore, a special allocation of tax benefits should conservatively be correlated with some economic component of what the partners take *out* of a partnership, not simply with what they put *in*.

The above hypothetical represents an extreme situation in which the general partners as a group have no interest in the operating profits or losses of the partnership. During 1973 the Service began to focus on what it considered to be a problem in the tax classification of a limited partnership in which the general

partners have a minimal interest. There is a substantial argument that a person who has a zero interest in the profits or losses of the partnership is not a partner. Several cases have considered the presence or absence of an interest in the profits of a partnership an important indicator of the status of a taxpayer as a partner.[93] Even if the general partner remains liable for partnership obligations under state law, it is hard to distinguish him from a third-party guarantor if he does not share in profits. A decision that a "general partner" is not a partner because he has no interest in profits may not result in classifying the organization as an association. Under local law there appear to be two basic possibilities: (1) a limited partnership is nonetheless formed because there has been "substantial compliance in good faith" with the Act's filing requirements; or (2) the "limited partners" have failed to create a limited partnership and have created a general partnership. Under the first possibility, limited liability, which Revenue Procedure 72-13 indicates is so critical, is present.

The Service's concern about this issue was officially presented in Revenue Procedure 74-17, in which it refused to rule on tax classification unless the combined interest of all the general partners in each item of partnership income, gain, loss, deduction, or credit is at least one percent of each item throughout the life of the partnership.[94] This would directly affect the hypothetical just discussed but is not that significant because, with one exception, it is easy to comply with at little cost by careful drafting. The exception is that state securities agencies may require that a priority on cash return be given to the investor-partners. The result is that there may be years in which all the cash flow goes to the limited partners and none to the general partners. Presumably, the imposition of such a priority will not preclude an advance ruling, especially if cash flow is not considered an item of "income, gain, loss, deduction or credit" within the meaning of Revenue Procedure 74-17.[95]

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[93]*See, e.g.,* Paul J. Kelly, 29 CCH Tax Ct. Mem. 1090 (1970); Hyman Podell, 55 T.C. 429 (1970); S. & M. Plumbing Co., 55 T.C. 702 (1971).

[94]Rev. Proc. 74-17, 1974-1 Cum. Bull. 438.

[95]For further discussion of special allocations and the "principal purpose" limitation, see Kaster, *Real Estate Limited Partnerships Special Tax Allocations,* 1973-2 N.Y.U. 31st Inst. on Fed. Tax. 1799; McGuire, *When Will a Special Allocation Among Partners Be Recognized?,* 37 J. Taxation 74 (1972); Weidner, *Passing Depreciation to Investor-Partners,* 25 S.C.L. Rev. 215 (1973).

## VII. Compensating the Promoter-Partner

### A. *Guaranteed Payments*

A major reaction to the restrictions on the deductibility of prepaid interest[96] has taken place in the area of compensation of promoter-partners. The Code provides that payments to a partner for services or for the use of his capital constitute "guaranteed payments" that are deductible by the partnership as if they were made to an outsider, provided they are "determined without regard to the income of the partnership."[97] In an attempt to maximize loss deductions, realty partnerships are documented to characterize as much as possible of the cash distributed to promoter-partners as deductible guaranteed payments for their services or for the use of their capital.[98] Because the recipient of the guaranteed payment must report it as ordinary income, intensified use of the guaranteed payment provision to generate partnership deductions could initially be viewed as an inoffensive trade-off with little loss to the Treasury. The reason the practice is offensive from a revenue-raising point of view is that the "guaranteed payments" are commonly made to promoter-partners who have substantial losses from other sources, and shelter-seeking investors are allocated the bulk of the partnership deduction. In effect, the guaranteed payment provision enables investors to assign their income to promoters who can absorb taxable income because of surplus losses from other sources.

The surprisingly prevalent practice of immediately deducting alleged guaranteed payments that would clearly be required to be capitalized if made to an outsider was recently laid to rest in *Jackson E. Cagle, Jr.*[99] In 1968 a promoter and two investors formed a partnership to deal in commercial property. By separate agreement the partnership agreed to pay the promoter-partner a management fee of $110,000, of which $90,000 was to be paid on or

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[96]*See* Rev. Rul. 68-643, 1968-2 Cum. Bull. 76; G. Douglas Burck, 63 T.C. 556 (1975).

[97]

> *To the extent determined without regard to the income of the partnership*, payments to a partner for services or for the use of capital *shall be considered as made to one who is not a member of the partnership*, but only for the purpose of section 61(a) (relating to gross income) and section 162(a) (relating to trade or business expenses).

Code § 707(c) (emphasis added).

[98]Less attractive options include having the promoters receive compensation in ways not deductible by the partnership, such as the sale of an asset to the partnership at a profit or the receipt of a more substantial share of net cash flow or proceeds of refinancing or sale.

[99]63 T.C. 86 (1974).

before December 31, 1968. The partnership claimed a deduction for the expenditure and distributed the resulting losses to the investor-partners. The court rejected the contention that payments falling within the definition of section 707(c) are automatically deductible and held that such payments must "run the gauntlet of section 162(a) in order to be deductible."[100] The court looked to the nature of the services performed and held that the expenditures were so related to the construction of a capital asset that they had to be capitalized.

Even more significant than the *Cagle* conclusion that capital expenditures cannot be made currently deductible by the use of section 707(c), a holding anticipated by most tax practitioners, is the very recent decision in *Edward T. Pratt*,[101] in which the court disallowed claims for guaranteed payments for services on the ground that they were based on "income." The taxpayers in *Pratt* were the cash-basis general partners of two accrual-basis limited partnerships, each formed for the purchase, development, and operation of a shopping center. Each limited partnership agreement obligated the general partners to expend their "best effort" to the management of the partnership. In return, the general partners as a class were to receive "a fee of five (5%) per cent of the initial Gross Base Lease Rentals . . . and then . . . ten (10%) per cent of all overrides and/or percentage rentals." The taxpayers agreed to divide the fees equally, the managerial services were performed, and the management fees were equally credited to accounts payable to them. The fees, which were reasonable in amount, were accrued and deducted annually by each partnership but were not paid to or reported by the taxpayers in the three years in question.[102]

The Tax Court held that the management fees did not qualify as guaranteed payments because they were based on "income."[103]

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[100] *Id.* at 94.

[101] 64 T.C. No. 17, CCH Tax Ct. Rptr. Current Regular Dec. No. 33, ¶ 189, at 2583 (May 8, 1974).

[102]

> The amount of management fees accrued by each of the partnerships in each of the years indicated is a reasonable and proper fee to pay for the services of managing a shopping center of the type of Parker Plaza and Stephenville. A like amount of fees would have had to be paid to a third party, not a general partner, as a fee for managing the shopping centers had such shopping centers been managed by a third party.

*Id.* at 2585.

[103]

> The amounts of the management fees are based on a fixed percentage of the partnership's gross rentals which in turn constitute partnership income. To us it follows that the payments are not de-

The holding that a fee in the form of a share of *gross* rentals is based on "income" will come as a shock to many who have interpreted the "determined without regard to the income of the partnership" language of section 707(c) to mean determined without regard to the availability of *net* income. Because the payments were based on gross income, the partnership, and hence the other partners, could be bound to pay the fees if other expenses exhausted partnership receipts. The court specifically found that all the partners intended the fees to be fully paid, and that the taxpayers could legally have caused the two partnerships to pay them. Unlike the charges to capital accounts in *Orrisch,* the credits to accounts payable in *Pratt* had economic significance. Therefore, the taxpayers presumably could have withheld current distributions to the limited partners until they had been paid and, if net receipts were insufficient, could have satisfied their claims out of the proceeds of refinancing or sale. *Pratt* would be less of a surprise if there were any indication in the opinion that the underlying leases were net leases. In that event, the fees would have been based on and payable out of surplus cash and would have looked less "guaranteed" by the partnership and more like an attempt to transform distributive shares of partnership income into deductible form.

The *Pratt* court rejected the argument that the management fees were deductible by virtue of the section 707(a) provision that a transaction between a partner and his partnership "other than in his capacity as a member of such partnership" shall "be considered as occurring between the partnership and one who is not a partner." Without deciding "whether a continuing payment to a partner for services was ever contemplated as being within the provisions of section 707(a)," the court concluded that section 707(a) would in no event apply to the instant case, because the taxpayers

> were to receive the management fees for performing services within the normal scope of their duties as general partners and pursuant to the partnership agreement. There is no indication that any one of the petitioners was engaged in a transaction with the partnership other than in his capacity as a partner.[104]

This rationale has tremendous potential impact because section 707(c) can be interpreted as a qualification of section 707(a) that is fully subject to the "other than in his capacity as a member of

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> termined without regard to the income of the partnership as required by section 707(c) for a payment to a partner for services to be a "guaranteed payment."

*Id.* at 2588.

[104]*Id.* at 2589.

the partnership" requirement.[105] Therefore, *Pratt* may be pointed to as authority for the proposition that general partners in a limited partnership cannot claim guaranteed payments for performing their essential duties under the partnership agreement; that, in reality, they are merely attempting to generate deductions by altering the form of distribution of their partnership income.

*Pratt* also involved guaranteed payments for the use of capital. The taxpayers had loaned funds to both partnerships and had received in return notes, secured by deeds of trust, wherein the partnerships agreed to repay principal plus interest at the rate of seven percent per annum without regard to partnership receipts or income. In the years in question, the partnerships did not pay the interest but credited it to the accounts payable to the taxpayers, who did not include the amounts as interest income in those years. As with the credits for management fees, the parties intended the interest payments to be made and the taxpayers had the right to cause payment. The Service, however, did not dispute that the interest payments were guaranteed payments. Rather, it sought to hold the taxpayers to the Regulation that recipients must report the guaranteed payments in the year when accrued by the partnership, whether the payments are actually made or not.[106] The taxpayers argued that the application of such a Regulation to cash-basis partners was an "overextension" of the Commissioner's authority, but the court applied the Regulation.

Although the guaranteed payment treatment for use of capital was not directly threatened by the *Pratt* decision, this victory by the Service in the area of guaranteed payments for services may lead to a more direct assault on guaranteed payments for capital. Many partnership agreements contain elaborate provisions for various types of loans from partners to the partnership. Many of these provisions are simply attempts to generate guaranteed payment deductions for "interest" payments to partners which would otherwise be received by them in the form of distributive shares of partnership income. The underlying "loans" may be vulnerable to the challenge that they are, in economic reality, contributions to capital rather than loans to the partnership.[107] There-

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[105]*See* Treas. Reg. § 1.707-1(a) (1958):

(a) *Partner not acting in capacity as partner.* A partner who engages in a transaction with a partnership other than in his capacity as a partner shall be treated as if he were not a member of the partnership with respect to such transaction. Such transactions include, for example, loans of money . . . by the partner to the partnership . . . and the rendering of services . . . by the partner to the partnership.

[106]*See id.* § 1.707-1(c).

[107]*See* Joseph W. Hambuechen, 43 T.C. 90, 100-01 (1964).

fore, no guaranteed payment for "interest" could be claimed by the partnership.

One final point should be made regarding guaranteed payments. In *Cagle* the deduction from the guaranteed payment was allocated to the two investor-partners. This is what is commonly done when there is a promoter-partner who has surplus losses from other sources. He can absorb the taxable income that must be reported by the recipient of a guaranteed payment and will allocate his share of the corresponding partnership deduction to his investor-partners in need of tax shelter. However, guaranteed payments are often made to a partner who does not want to absorb taxable income. There are situations in which such a partner is specially allocated the entire corresponding partnership deduction so he will not have to pay tax on the guaranteed payment.[108] There is no authority precisely on point, but it would appear that such an allocation violates the "principal purpose" limitation[109] because it allocates the deduction away from those who bear the economic burden of the expense.

### *B. Receipt of a Profits Interest*

A common practice in the real estate area is for lawyers, accountants, architects, and other professionals to take a "piece of the action" in the form of a profits interest in lieu of or in addition to immediate cash payment for services rendered. The popularity of the practice was explained in large part by the assumption that the receipt of a profits interest in a partnership is not a taxable event. Section 721 provides that no gain or loss will be recognized to a partnership or its partners on "a contribution of property to the partnership in exchange for an interest in the partnership."[110] However, the Regulations under section 721 also mention the receipt of a partnership interest in exchange for *services*:

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[108]*See* Cowan, *Receipt of a Partnership Interest for Services*, 1974-2 N.Y.U. 32D INST. ON FED. TAX. 1501, 1521-22. *See also* Boffa, *Tax Problems in Compensating the Joint Venture Partner*, 1 J. REAL ESTATE TAXATION 131, 142 (1974), in which the author suggests that promoter-partners who must include in income the value of profits interests received in exchange for services be specially allocated the corresponding deduction to which the partnership is entitled.

[109]*Compare* Treas. Reg. § 1.721-1(b)(2) (1956). When a partner receives an interest in a partnership in exchange for services rendered to a partner, "it is not deductible by the partnership, but is deductible only by such partner to the extent allowable under this chapter." *Id.* If it is for services rendered to the partnership, "it is a guaranteed payment for services under section 707(c)." *Id.*

[110]*Id.* § 1.721-1(a) states that section 721 "shall not apply to a transaction between a partnership and a partner not acting in his capacity as a partner since such a transaction is governed by section 707."

> Normally, under local law, each partner is entitled to be repaid his contributions of money or other property to the partnership (at the value placed upon such property by the partnership at the time of the contribution) . . . . To the extent that any of the partners gives up any part of his right to be repaid his contributions (as distinguished from a share in partnership profits) in favor of another partner as compensation for services, . . . section 721 does not apply. The value of an interest in such partnership capital so transferred to a partner as compensation for services constitutes income to the partner under section 61.[111]

This language was widely interpreted to mean that the receipt of an interest in partnership *capital*[112] in exchange for services was a taxable event, but the receipt of an interest in the partnership *profits* in exchange for services was not a taxable event. The latter proposition has been defended on the basis of the parenthetical in the above-quoted Regulation that excepts he receipt of a profits interest from the declaration of the taxability of a receipt of a capital interest. Under the "no taxable event" interpretation, the recipient obtains a zero basis in his partnership interest,[113] must subsequently report as ordinary income his allocable share of the partnership profits, and pays capital gain on the sale of the interest.

To the disbelief of many, the Tax Court in *Sol Diamond*[114] rejected the contention that section 721 requires nonrecognition of a receipt of an interest in partnership profits in exchange for services. Diamond was a mortgage broker who obtained numerous loans for experienced builders from a savings and loan association. Diamond received commissions from the borrowers, several of

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[111]*Id.* § 1.721-1(b)(1).

[112]The interest in partnership "capital" described in the Regulations is the right to be repaid contributions to capital. Many assume that this is adjusted by shares of profits and losses of the partnership. *See, e.g.*, Cowan, *supra* note 108, at 1513-14, wherein the author states:

> The litmus test of an interest in capital at any moment of time within the meaning of Section 721 can be phrased as follows: Convert all of the partnership assets into cash at then fair market values, pay off all liabilities, and distribute the balance. The amount that each partner would receive is his interest in capital. A partner's capital account, then, is the value of his equitable interest in the net assets of the partnership. A profits interest, on the other hand, is a right to share in future changes of net worth, either by way of outside income or by way of changes in the values of partnership assets.

[113]The zero basis would be increased to the extent he shares in partnership liabilities.

[114]56 T.C. 530 (1971), *aff'd* 492 F.2d 286 (7th Cir. 1974).

which he split with certain officers of the savings and loan association. Diamond received the interest in question from a Mr. Kargman, an experienced syndicator, as compensation for obtaining one hundred percent financing of the purchase price of an office building. It was agreed that Kargman would pay all acquisition costs above the amount of financing, and that Kargman and Diamond would share profits in a 40-60 ratio, respectively, and would be "chargeable with all losses in the same proportions."[115] Net proceeds of any subsequent sale of the building were to be divided in the same ratio, after first being applied to reimburse Kargman for any acquisition expenditures he incurred. Diamond was not obligated to contribute any acquisition costs nor was he obligated to provide further services. Three weeks after closing the purchase of the building, Diamond sold his interest for $40,000 and subsequently reported that amount as a short-term capital gain from the sale of a partnership interest.[116]

The Tax Court could not resist denying Diamond capital gains treatment for the receipt of $40,000 for services performed just a few weeks earlier. It concluded that a contribution of services was not a contribution of "property" within the nonrecognition provisions of section 721. As to the parenthetical in the section 721 Regulations, which according to popular belief mandated nonrecognition of the receipt of a "profits" interest for services, the court said its effect is "obscure." The court concluded that the "opaque draftmanship" in the Regulations was insufficient to override the general rule that the fair market value of property received for services must be included in gross income.[117] In so doing, the court did not discuss the difficult question of whether the interest involved was an interest in "capital" or "profits" and substantially lessened the importance of the distinction by its summary dismissal of the section 721 Regulations.[118]

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[115]56 T.C. at 537.

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> In the case of a sale or exchange of an interest in a partnership . . . gain or loss shall be considered as gain or loss from the sale or exchange of a capital asset, except as otherwise provided in section 751 (relating to unrealized receivables and inventory items which have appreciated substantially in value).

CODE § 741.

[117]CODE § 61(a); Treas. Reg. § 1.61-2(d)(1) (1966).

[118]The Tax Court did leave open the possibility of future application of the parenthetical:

> Regardless of whether there may be some kind of equitable justification for giving the parenthetical clause some limited form of affirmative operative scope, as perhaps where there is a readjustment of partners' shares to reflect services being performed by one of the partners, we cannot believe that the regulations were ever intended to

An important question not directly presented by the facts nor discussed in the Tax Court's opinion is whether a service partner who reports as ordinary income the value of the partnership interest when received must again pay ordinary income tax on his distributive shares of partnership profits as they are earned. For example, if a partner must include in ordinary income the fair market value of the right to receive $1,000 a year for several years in the future, will he again be taxed at ordinary income rates on the $1,000 payments as they are actually received? Or can the basis obtained in his interest by paying tax on its fair market value be amortized as the profits are earned? In affirming the Tax Court, the Seventh Circuit addressed the objection that there will be double taxation if the right to share in future profits and the subsequent receipts of those profits are both taxed. The court said that the "absence of a recognized procedure for amortization [did not] militate against the treatment of the creation of the profit share as income."[119] However, the court found a need for "the promulgation of appropriate regulations to achieve a degree of certainty" in this matter.[120]

*Vestal v. United States*[121] throws substantial doubt on the extent to which a taxpayer may report a low market value in the year of receipt based on the contingent nature of future profits and subsequently report any gain on disposition as appreciation in value of a capital asset. Vestal knew assignees of an oil and gas lease who were attempting to sell limited partnership interests to raise money to drill additional wells required of them by the lease assignment. In 1962, he contacted four investors who supplied the remaining needed funds, became limited partners, and agreed to pay him a finder's fee. Each agreed in writing to convey to Vestal one-eighth of his limited partnership interest upon recovery of his investment in the partnership, plus six percent interest compounded semiannually. Two years later, the general partners sold the partnership's assets, and the purchase price was paid in three yearly installments. The four investors, after receiving their share of the purchase price and deducting the amount of their investment plus interest, issued checks to Vestal totaling $139,730 for one-eighth of the remaining balance.

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bring section 721 into play in a situation like the one before us.
56 T.C. at 546.

[119]Diamond v. Commissioner, 492 F.2d 286, 290-91 (7th Cir. 1974), *aff'g* 56 T.C. 530 (1971).

[120]Peter P. Risko, 26 T.C. 485 (1956), has been cited as authority for the proposition that the amount included in income may be amortized when the partnership has a determinable life.

[121]498 F.2d 487 (8th Cir. 1974), *rev'g* 73-1 U.S. Tax Cas. ¶ 9260 (W.D. Ark. 1973).

The district court had concluded that the compensation agreements gave Vestal an interest in a capital asset which had a fair market value of $29,375 when executed in 1962 and should have been reported in that year. Vestal had not reported the value of the interests in 1962, and the statute of limitations had run against the government for that year. The court directed that the gains from the 1964 disposition be taxed at long-term capital gains rates, using the $29,375 value which should have been reported in 1962 as the basis in computing the gain.

The Eighth Circuit Court of Appeals reversed, accepting the Government's position that the interests obtained by Vestal in 1962 "were contingent, conditional, and speculative, and as a matter of law, did not constitute income taxable to Vestal in 1962."[122] The court admitted that Vestal's rights had value in 1962, but said that "such recognition does not support a view that Vestal received income under the federal tax laws." Clearly the court did not want to encourage taxpayers to undervalue contingent interests received for services and subsequently claim capital gains treatment on disposition.[123]

*Diamond* was not cited to the *Vestal* court until Vestal's petition for rehearing, in which he raised it as authority for the proposition that the value of his interest was income in 1962. The court denied the petition and said that the effect of its decision was to tax Vestal upon his acquisition of "the actual joint venture interests" and was consistent with the decision in *Diamond* that the taxable event was "when the parties actually acquired the building to be held as a joint venture."[124] However facile the court's reconciliation of the two cases, they both clearly indicate strong opposition to capital gains treatment of compensation for services. In *Diamond*, both the Tax Court[125] and the Seventh Circuit suggested "the possibility that Diamond would not in any event be entitled to

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[122] 498 F.2d at 490.

[123]

> Undervaluation would allow compensatory income taxable at ordinary rates to be treated as capital appreciation upon taxpayer's actually receiving the performance promised him by the contract. When dealing with a situation such as the present where taxpayer holds an executory contingent contract payable in the future, the tax laws should not be construed so stringently, on the one hand, so as to require a taxpayer to pay an income tax on its estimated value; nor should they be construed so loosely, on the other, as to permit him to establish a basis for those same contract rights in the absence of a showing that there was an actual trading or marketing of those rights.

*Id.* at 493-94 (citation omitted).

[124] *Id.* at 496 (order on petition for rehearing).

[125] 56 T.C. at 547, n.16.

capital gains treatment of his sale of a right to receive income in the future, but did not decide the question."[126]

Service partners may find some relief from *Diamond* and *Vestal* under section 83, added by the Tax Reform Act of 1969. Section 83, although debated and passed in the context of corporate executive compensation, can readily be interpreted to apply to partnership transactions as well. Indeed, the Proposed Regulations under section 721 indicate that section 83 will be applied to partnership transactions.[127] Section 83 provides that the fair market value of property transferred in connection with services is taxable at ordinary income rates at the time of receipt if the property is either transferable or not subject to a substantial risk of forfeiture. If the interest is nontransferable and forfeitable when received, it is taxable when it first becomes either transferable or nonforfeitable.[128] However, even if the interest is forfeitable and not transferable, the recipient may elect to pay ordinary income tax on the value of the interest in the year in which it is received.[129] The advantage of this election is that subsequent increases in value prior to the lapse of the restrictions will be taxed only as a capital gain upon disposition of the property.[130]

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[126] 492 F.2d at 287.

[127] Proposed Treas. Reg. § 1.721-1(b)(1)(i), 36 Fed. Reg. 10,799 (1971).

> If the partnership interest is transferred after June 30, 1969 (except to the extent paragraph (b) of § 1.83-8 applies), then the transfer of such interest in partnership capital shall be treated as a transfer of property to which section 83 and the regulations thereunder applies.

The Proposed Regulations restate the parenthetical in the present section 721 Regulations that was at issue in *Diamond*. See notes 114-18 *supra*. Because *Diamond* ignored the parenthetical and the distinction between capital and profits for the purposes of section 721, it would seem that the Proposed Regulations, published prior to *Diamond*, cause all receipts of partnership interests for services to be governed by section 83.

[128] CODE § 83(a).

[129] CODE § 83(b).

[130]

> *If this election is made,* section 83(a) and the regulations thereunder, do not apply with respect to such property, and except as otherwise provided in section 83(d)(2) and the regulations thereunder, *any subsequent appreciation in the value of the property is not taxable as compensation.* In computing the gain or loss from the subsequent sale or exchange of such property, its basis shall be the amount paid for the property increased by the amount included in gross income under section 83(b).

Proposed Treas. Reg. § 1.83-2(a), 36 Fed. Reg. 10,789-90 (1971) (emphasis added). However, if such election is made and "such property is subsequently forfeited, no deduction shall be allowed in respect of such forfeiture." CODE § 83(b). For further discussion of the applicability of section 83 to receipts of partnership interests, *see* Cowan, *supra* note 108, at 1527-40.

## VIII. Preadmission Losses

In a sense, the ultimate rub of the present-day realty tax shelter is the fairly common practice of admitting shelter-hungry investors to partnerships at the end of the year and giving them an allocation of losses as if they had been partners for the entire year. Many defend the practice and, at the same time, advise their clients to refrain from flaunting its existence. For example, some practitioners will counsel their clients to avoid written predictions of preadmission losses to year-end admittees. The two basic arguments made in defense of the practice are that (1) it is a legitimate exercise of the flexibility offered by section 704(a) to determine partnership allocations in the partnership agreement and (2) it is specifically authorized by the rule of section 761(c) that amendments to partnership agreements relate back to the beginning of the taxable year.[131]

The first argument is that retroactive allocations of losses, if they are subject to scrutiny at all, are special allocations which will be disregarded only if they violate the "principal purpose" limitation of section 704(b)(2). At first, it might seem peculiar to defend a practice by asserting that it is subject to such a broadly-stated limitation. Nevertheless, this is an understandable position for advocates of retroactive loss allocations. It concedes nothing, because no one has ever suggested that retroactive allocations are exempt from the principal purpose limitation. More importantly, uncertainties about the application of the principal purpose limitation have delayed its development as an effective rationale against partnership tax avoidance schemes. It is fairly easy to provide at least a paper correlation between the retroactivity of the loss allocation and some economic incident of the partnership and claim that is sufficient under the sparse law on point. In short, the argument is an attempt to create a safe harbor within the virtually nonexistent limitations of section 704(b)(2).

The argument based on section 761(c) finds some support in the recent case of *Norman Rodman*,[132] in which the Tax Court required a late-admitted partner to report his share of partnership gain on the basis of the full taxable year. The joint venture in *Rodman* was formed in 1955 with four equal participants. On No-

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[131]

> For purposes of this subchapter, a partnership agreement includes any modifications of the partnership agreement made prior to, or at, the time prescribed by law for the filing of the partnership return for the taxable year (not including extensions) which are agreed to by all the partners or which are adopted in such other manner as may be provided by the partnership agreement.

Code § 761(c).

[132] 32 CCH Tax Ct. Mem. 1307 (1973).

vember 2, 1956, one of the participants withdrew by selling his entire interest to the remaining participants. Three days later, the son of one of the remaining participants was admitted as a twenty-two percent participant. A deficiency was assessed at the venture level for 1956, and the question was whether the Service could hold the son liable for the deficiency as if he had participated for the entire year.

The son argued that his share of profits and losses was intended to begin with his admission to the venture. The Servcie alleged and proved that the intent had been to retroactively amend the joint venture agreement so that the son would share in the entire year's profits and losses. Indeed, on the venturer's 1956 partnership return, the son had been allocated twenty-two percent of the partnership losses for the entire year, and he had filed his individual return on the same basis. The Service merely wanted to hold him responsible for the same period for what it determined to be a gain rather than a loss, and the court held it could.

The commentators generally agree that *Rodman* is weak authority for retroactive allocations of preadmission losses.[133] First, the court clearly stated that proration of income or loss was required with respect to the partner who withdrew. Second, the court did not satisfactorily discuss the issue of retroactivity, and its precise reasoning is unclear.[134] Although the interests of the three remaining partners were reduced upon the son's admission, the court did not mention section 706(c)(2)(B), which would appear to require proration. Third, the extent to which retroactivity was actually involved is unclear, because the government concluded that Rodman "was active in the joint venture prior to the time he was allegedly brought into the venture."[135] Fourth, the government, not the taxpayer, attempted to establish retroactivity—of taxable income, not tax losses. The court may have felt that because the son had claimed losses for the entire year, it was not unfair to hold him to his claim to the entire year when the losses were determined to be gains. Finally, the holding is questionable insofar as the son bore a share of the tax burden greater than his share of economic benefits.

In short, despite *Rodman*, there remains a clear possibility that either one of two provisions may be applied to deprive year-

[133]Cowan, *Allocating the Tax Shelter Retroactively: The* Rodman *Case*, 2 J. Real Estate Taxation 5 (1974); Koff & Hammer, *Retroactive Allocations: The Case Against* Rodman, *id.* at 18; McGuire, *Retroactive Allocations Among Partners: The* Rodman *Decision*, 52 Taxes 325 (1974); Weidner, *Year-end Sales of Losses in Real Estate Partnerships*, 1974 U. Ill. L.F. 533.

[134]In fairness to the court, it should be pointed out that the court and subsequent commentators have noted that the case was poorly litigated.

[135]McGuire, *supra* note 133, at 325 n.3.

end admittees the benefit of retroactive allocations of preadmission losses. First, section 708 provides that a partnership is terminated for tax purposes if there is a "sale or exchange" of fifty percent or more of the total interest in partnership capital and profits. This provision clearly separates termination of a partnership for federal income tax purposes from dissolution under local law.[136] If the admission of new partners constitutes such a "sale or exchange," the newly admitted partners will be members of a new partnership, rather than the one that incurred the losses. Even if there is no termination under section 708, proration may be required. Section 706(c)(2)(B) provides that the taxable year of the partnership shall not close with respect to a partner who sells or exchanges less than his entire interest in the partnership,

> or with respect to a partner whose interest is *reduced,* but such partner's distributive share of items described in section 702(a) shall be determined by taking into account his *varying interests in the partnership during the taxable year.*[137]

In short, it can be argued that the interests of initial partners are "reduced" when newly admitted partners are passed shares in net cash flow, proceeds of refinancing or sale, etc., such that year-end admittees may only share in the partnership losses for the period of the year during which they were members. The general policy against trafficking in tax losses would support the conclusion that these two proration requirements apply to year-end admittees and are not superseded by the more general provisions of sections 704(a) and 761(c).[138]

## IX. Conclusion

In the early part of the nineteenth century, limited partnership statutes were enacted to give profit-sharing passive investors a corporate-type freedom from enterprise liability prior to the general availability of the corporate form. The Code has no separate classification for limited partnerships, which will be governed by the partnership provisions of Subchapter K unless they are classified as corporations for tax purposes. The present classification Regulations are remnants of the attempt to deny corporate classification to professional associations and are heavily biased

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[136]See Treas. Reg. § 1.706-1(c)(1) (1956).

[137]Code § 706(c)(2)(B) (emphasis added).

[138]The refinement of the rules concerning retroactive allocation is presently under the consideration of the House Ways and Means Committee.

toward classifying as a partnership for tax purposes anything that is a partnership, general or limited, under local law.

The Service, however, has issued a series of Revenue Procedures that indicate that partnership classification may be withheld from limited partnerships that do not have general partners with substantial assets, that employ allocation systems that do not accord all partners significant shares in all items of income and loss, and that utilize deduction-generating and accelerating devices to such an extent as to suggest that the partnership is primarily for the purpose of generating and distributing tax losses rather than for economic profit. The basic reason for going beyond the Regulations is the tremendous popularity of limited partnerships to deliver tax losses to high-bracket limited partners who have all the limited liability of the corporate form and who nevertheless claim the pass-through of losses available to partnerships. Furthermore, limited partners deduct tax losses far in excess of their economic investment because of a Regulation stating that limited partners may claim partnership losses beyond cash investment to the further extent they share in partnership liabilities that are fully non-recourse. The Treasury has considered withdrawing this Regulation, but has not yet done so. The idea will continue to have appeal until some sort of reform is enacted, or until the popularity of the limited partnership somehow wanes. In the meantime, the Service can be expected to become more strict in its requirements that something approaching significant personal liability be present, on the use of certain devices to generate and accelerate losses, such as guaranteed payments and prepayments of interest, on allocation systems designed to distribute tax benefits independent of economic benefits, and on retroactive allocations of preadmission losses.

# Comments

## Bank Holding Company Regulatory Experience Since 1970

JOHN T. MASTEN*

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Throughout the history of American banking there has been public concern regarding unsound banking practices. At the same time a fear of excessive concentration of financial, economic, and political power has prevailed. In this tradition, Congress passed the Bank Holding Company Act of 1956,[1] subsequently amended in 1966[2] and 1970,[3] which subjects bank holding company acquisitions and activities to approval by the Federal Reserve System. By this legislation, Congress has created something of a novelty in American law—it has charged a regulatory body with shaping the structural profile of an industry. The purpose of this Comment is to examine the Federal Reserve's role as regulator of bank holding companies since 1970, when one-bank organizations were added to the multi-bank firms already subject to its jurisdiction.[4] Of particular interest are the policies it has developed in coming to grips with the issue of excessive concentration. The discussion that follows reviews bank holding company legislation, current administrative procedures under the Act, and Board of Governors decisions in appellate cases for acquisition approvals. The concluding section offers some observations on current and future problems in the area of bank holding company regulation.

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[1]Act of May 9, 1956, ch. 240, 70 Stat. 133 (codified at 12 U.S.C. §§ 1841-48 (1970)).

[2]Act of July 1, 1966, Pub. L. No. 89-485, 80 Stat. 236 (codified at 12 U.S.C. §§ 1841 to -43, -48, -49 (1970)).

[3]Act of Dec. 31, 1970, Pub. L. No. 91-607, 84 Stat. 1760 (codified at 12 U.S.C. §§ 1841 to -43, -49, -50 (1970)).

[4]*Id.* § 101(a) (codified at 12 U.S.C. § 1841 (1970)).

## I. Holding Company Legislation

The Bank Holding Company Act of 1956 required that all holding companies that owned or controlled twenty-five percent or more of the stock of two or more commercial banks be registered with the Federal Reserve Board of Governors.[5] The Act compelled these companies to divest themselves of control over all nonbank-related corporations,[6] with exceptions allowed only for activities of a financial, fiduciary, or insurance nature and those other activities determined to be so closely related to the business of managing or controlling banks as to be "a proper incident thereto."[7] The Act further required Board approval for any bank acquisition. In reaching its decision, the Board was required to consider: (1) the financial history and conditions of the banks involved, (2) their earnings propects, (3) the general characteristics of management, (4) the convenience, needs, and welfare of the communities and areas concerned, and (5) whether or not the "effect of such acquisition . . . would be to expand the size or extent of the bank holding company system involved beyond limits consistent with adequate and sound banking, public interest, and the promotion of competition in the field of banking."[8] The first four factors direct Board attention toward traditional banking factors. The fifth requires that it consider the competitive aspects of the acquisition. All of these factors were later incorporated in the Bank Merger Act of 1960, which requires public agency approval of bank mergers.[9]

Both statutes, however, were ambiguous as to the relative weight to be accorded each of these factors. Moreover, the question of the application of antitrust laws to bank acquisitions and mergers was left open. The latter issue was conclusively settled by Supreme Court action in the early 1960's. In *United States v. Philadelphia National Bank*[10] and *United States v. First National Bank & Trust Co.*,[11] the Court ruled that bank mergers (and by extension, bank holding company acquisitions) approved by fed-

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[5]Act of May 9, 1956, ch. 240, § 2(a), 70 Stat. 133.

[6]12 U.S.C. § 1843(a) (1970).

[7]*Id.* § 1843(c)(8).

[8]Act of May 9, 1956, ch. 240, § 3(c), 70 Stat. 133, 135. The 1966 Amendments substituted for this criteria the following:

> In every case, the Board shall take into consideration the financial and managerial resources and future prospects of the company or companies and the banks concerned, and the convenience and needs of the community to be served.

12 U.S.C. § 1842(c) (1970).

[9]Act of May 13, 1960, Pub. L. No. 86-463, 74 Stat. 173 (codified at 12 U.S.C. § 1828(c) (1970)).

[10]374 U.S. 321 (1963).

[11]376 U.S. 665 (1964).

eral banking agencies could be challenged by the Attorney General under antitrust laws. In the former case, the Court held that the proposed merger of two large Philadelphia banks, which would have resulted in a single bank controlling thirty-six percent of the bank deposits in a four-county area, was sufficiently anticompetitive as to be in violation of section 7 of the Clayton Act.[12] The decision also established that commercial banking was a "distinct line of commerce."[13] As a consequence, the banking market was to be distinguished from that of savings and loan associations, credit unions, and other thrift institutions. With respect to banking factors, the Court maintained:

> [A] merger the effect of which may be substanially to lessen competition is not saved because, on some ultimate reckoning of social or economic debits and credits, it may be deemed beneficial . . . . In proscribing anticompetitive mergers, benign and malignant alike, we must assume that some price must have to be paid.[14]

In 1966, the Bank Holding Company and Bank Merger Acts were revised to accord with these Court decisions. In amendments to both statutes, Congress affirmed the applicability of antitrust laws to bank acquisitions and mergers that would substantially lessen competition or tend to create a monopoly.[15] Competition became the paramount factor. Exceptions were allowed primarily when the anticompetitive effects were clearly outweighed by the probable beneficial effects of the transaction in meeting the convenience and needs of the community to be served.[16]

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[12] 374 U.S. at 355-72.

[13] *Id.* at 356.

[14] *Id.* at 371.

[15] Act of July 1, 1966, Pub. L. No. 84-485, § 7(a), 80 Stat. 236. The amendments to the Bank Holding Company Act are codified at 12 U.S.C. § 1842(c) (1970) and those to the Bank Merger Act at *id.* § 1828(c).

[16] 12 U.S.C. § 1842(c) (1970) provides in relevant part:

> The Board shall not approve—
>
> . . . .
>
> (2) any . . . proposed acquisition or merger or consolidation under this section whose effect in any section of the country may be substantially to lessen competition, or tend to create a monopoly, or which in any other manner would be in restraint or [*sic*] trade, unless it finds that the anticompetitive effects of the proposed transactions are clearly outweighed in the public interest by the probable effect of the transaction in meeting the convenience and needs of the community to be served.

In United States v. First City Nat'l Bank, 386 U.S. 361, 366 (1967), the Court held that the burden of proving that considerations of convenience and need outweigh the anticompetitive effects of the merger or acquisition rests upon the defendant company.

Despite this revision, it was soon evident that the Bank Holding Company Act was not sufficiently encompassing. Particular concern arose over the fact that a holding company which owned or controlled twenty-five percent or more of the stock of only *one* bank did not need to register under the Act and thus was not subject to the required divestiture of its nonbanking business. Since one-bank holding companies were exempt from the Act, they were unrestricted as to the types of business that they could operate. Consequently, a substantial number of large banks formed one-bank holding companies and acquired subsidiaries that engaged in numerous commercial activities. Twin incentives existed for such reorganization. One incentive was the need to obtain new sources of funds from which loans could be made. For many years the primary source of bank funds—demand deposits—had declined as a percentage of liabilities, and imaginative bank managements were forced to look elsewhere for funds. The second incentive was that bankers had found that their investment in computers and trained personnel gave them excess productive capacity, and that they could offer additional services by utilizing equipment and skills already at hand. This possibility drew management's attention to product expansion, since they had already made the initial investment required to sell insurance, underwrite revenue bonds, perform accounting, data processing, and leasing services, and operate mutual funds.

The one-bank holding company appealed as a vehicle which offered the flexibility needed to obtain more funds and to expand services. However, this organizational emergence threatened the traditional separation of banking and commerce. As a result, Congress passed the Bank Holding Company Act Amendments of 1970.[17] The Amendments eliminated the legal distinction between one-bank and multi-bank holding companies by defining a bank holding company as "any company which has control over any bank or over any company that is or becomes a bank holding company."[18] The Board of Governors of the Federal Reserve System was given discretion to determine that ownership, control, or voting power over as little as five percent of the shares of a company or bank could constitute control.[19]

The Amendments broadened section 4(c)(8) of the Act by establishing a two-part test for nonbank acquisitions.[20] Under this section, the Board was required to determine whether an activity was so closely related to the business of banking or managing

[17] Act of Dec. 31, 1970, Pub. L. No. 91-607, 84 Stat. 1760 (codified at 12 U.S.C. §§ 1841 to -43, -49, -50 (1970)).

[18] *Id.* § 101(a) (codified at 12 U.S.C. § 1841(a)(1) (1970)).

[19] *Id.* (codified at 12 U.S.C. § 1841(a)(2), (3) (1970)).

[20] *Id.* § 103 (codified at 12 U.S.C. § 1843(c)(8) (1970)).

or controlling banks as to be a proper incident thereto. More importantly, in deciding the issue of proper incidence, the Board had to consider whether the performance of services by an affiliate of a holding company could reasonably be expected to produce benefits to the public, such as greater convenience, increased competition, or gains in efficiency, that would outweigh possible adverse effects, such as undue concentration of resources, decreased or unfair competition, conflicts of interests, or unsound banking practices. Thus, operations that might be acquired by holding companies were no longer restricted to those of a financial, fiduciary, or insurance nature. The test, balancing public benefits against adverse effects, extended the notion of what was to be a proper incident to banking. The determination of this matter was left with the Federal Reserve Board of Governors.

## II. Administration of the Bank Holding Company Act As Amended

Under its rules regarding delegation of authority, the Board of Governors shares the burden of administering the Act with the Federal Reserve Banks.[21] The application procedure is initiated at the District Bank level, where an acquisition request is reviewed for legal sufficiency and informational adequacy. Following this preliminary screening, notice of an accepted application is given to the Board of Governors,[22] who in turn inform the Comptroller of the Currency if the firm proposed to be acquired is a national bank or a bank located in the District of Columbia.[23] If the bank to be acquired is state-chartered, the appropriate state authority is notified.[24] In the case of a nonbank acquisition under section 4, the Board publishes a notice of this application in the *Federal Register*, giving interested parties an opportunity to express their views.[25]

In the meantime, each application is reviewed by the Federal Reserve Bank to see if it meets conditions of approval. The determinations are based upon general guidelines provided by the Board as well as precedents established within the particular Federal Reserve district. As a rule, an application is approved if all relevant departments of the Reserve Bank recommend ap-

[21] 12 C.F.R. § 265.2(f)(19)-(24) (1974).

[22] *Id.* § 262.3(a), (b).

[23] 12 U.S.C. § 1842(b) (1970). *See also* 12 C.F.R. § 225.3 (1974).

[24] 12 U.S.C. § 1842(b) (1970). *See also* 12 C.F.R. § 225.3 (1974).

[25] 12 C.F.R. § 225.4(a) (1974). Such notice is published only in the event that the Board believes the holding company has a reasonable basis for believing that the proposed acquisition is closely related to banking or managing or controlling banks.

proval, if no substantive objection to the proposal has been made by a Board member, bank supervisory agency, the United States Department of Justice, or a member of the public, if no significant policy issue is raised by the proposal as to which the Board has not expressed its view, and if certain competitive and banking criteria are met.[26] With respect to competition, it is generally expected that:

1. Applicant is not one of the dominant banking organizations in the state, and, unless the proposed subsidiary is a proposed new bank, Applicant will control no more than 15 percent of the total deposits in commercial banks in the state after consummation of the proposal;
2. if the bank to be acquired is an existing bank and if no banking offices of Applicant's existing subsidiary bank are located in the same market as the proposed subsidiary, the proposed subsidiary has no more than $25 million in total deposits or controls no more than 15 percent of deposits in commercial banks in the market;
3. if the bank to be acquired is an existing bank and if any of Applicant's existing subsidiary banks compete in the same market as the proposed subsidiary, Applicant will control no more than 10 percent of total deposits in commercial banks in the market after consummation;
4. if the bank to be acquired is a proposed new bank, bank subsidiaries of Applicant will not hold in the aggregate more than 20 percent of the total deposits in commercial banks in the relevant market area and Applicant will not be one of the dominant banking organizations in the state; and
5. neither Applicant nor the bank to be acquired has entered into or proposes to enter into any agreement with any director, officer, employee, or shareholder of the bank that contains any condition that limits or restricts in any manner the right of such persons to compete with Applicant or any of Applicant's existing or proposed subsidiaries.[27]

The banking factors taken into consideration mainly involve determinations of holding company capital adequacy and acquisition debt. For instance, acquisition debt must be amortized within

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[26] *Id.* § 265.2(24).

[27] *Id.* § 265.2(24)(xii)-(xv). Qualification 5 is found at 60 FED. RES. BULL. 358-60 (1974).

a reasonable period of time, such period normally not exceeding twelve years.[28]

In the case of nonbank acquisitions, a competitive limitation is that:

> If Applicant or any of Applicant's existing or proposed nonbanking subsidiaries compete in the same geographic and product market as any proposed subsidiary, the resulting organization will not control more than 10 percent of that product or service line after consummation of the proposal.[29]

While the guidelines denote areas of general Board concern, they do not cover all situations.

In addition to the other conditions, the Federal Reserve Bank must determine whether the proposed activity falls within the meaning of section 4(c)(8). In Regulation Y,[30] which is periodically amended, the Board has listed a number of permissible activities. As of January, 1975, a bank holding company could, with certain qualifications, make or acquire loans and other extensions of credit for its own account or for the account of others, operate as an industrial bank, service loans and other extensions of credit, and perform trust activities.[31] The Regulation also permitted the holding company to act as an investment or financial advisor or as an insurance agent or broker, to lease real and personal property, to make equity and debt investments in corporations or projects designed primarily to promote community welfare, and to provide bookkeeping, data processing, courier services, and management consulting advice to nonaffiliated banks.[32]

Each of the above categories carries exceptions and limitations. For instance, conventional life insurance may be sold by banks in very small communities. Data processing must be bank-related; it cannot be employed for accounting services. The term courier services comprises messengers, but not armored car deliveries.

## III. Decisions Under the Act

Once an application is approved, the holding company may proceed with the acquisition. Should a particular application be denied, however, and its proponents have reason to believe in its viability, it is presented to the Board for review. As a matter of fact, by far the major proportion of the applications, eighty

[28] 12 C.F.R. § 265.2(24)(vi)(a) (1974).
[29] *Id.* § 265.2(24)(viii).
[30] *Id.* § 225.1 to .4.
[31] *Id.* § 225.4.
[32] *Id.*

percent, go to the appellate level,[33] since most cases do not fall within the delegated guidelines. The Board thus operates largely on a case-by-case basis. In doing so, it has built a body of administrative law in the bank holding company area.

It becomes worthwhile to examine this "corpus juris" in order to gain a better understanding of Board policies and to discern possible trends with respect to concepts the Board considers of increasing importance. The following review deals solely with Board denials since 1970, when the Act was amended to include one-bank holding companies. An analysis of what is *not* permitted may help to distinguish the key hurdles that must be overcome if a bank holding company is to be successful in its application.

### A. *Bank Acquisitions*

The Board has denied about six percent of the applications it has received under section 3 of the Act, which governs acquisitions of banks. As shown in Table I below, applications have been turned down for reasons of existing and potential competition, financial considerations, and transactional factors. This last item encompasses the various aspects of the acquisition transaction—the mechanics of the formation or acquisition. For example, is the offer substantially equal among all shareholders? Are there post-employment contracts that would constitute an unreasonable restraint of trade? While these and similar matters are not specifically alluded to in the Act, they can be considered a logical by-product of the statutory requirement that financial and managerial resources and future prospects of the holding company be considered.[34]

TABLE I

Bank Acquisitions Denied Under Section 3
of the Bank Holding Company Act of 1970

| | 1971 | 1972 | 1973 | 1974 | Total |
|---|---|---|---|---|---|
| Reason for Denial: | | | | | |
| (a) Existing Competition | 2 | 7 | 8 | 11 | 28 |
| (b) Potential Competition | 1 | 4 | 6 | 7 | 18 |
| (c) Financial Considerations | 1 | 5 | 3 | 13 | 22 |
| (d) Transactional Factors | | | 1 | 2 | 3 |
| Totals | 4 | 16 | 18 | 33 | 71 |
| Both (a) and (b) | | 1 | 3 | 1 | 5 |
| (a) and/or (b) and (c) | | | | 1 | 1 |
| Adjusted totals[35] | 4 | 15 | 15 | 31 | 65 |

[33] Shay, *Bank Holding Companies and the Fed: Whose Board?*, 91 BANKING L.J. 344 (1974).

[34] THE BANK HOLDING COMPANY, 1973, at 32 (R. Johnson ed. 1973) [hereinafter cited as JOHNSON].

[35] To avoid double counting, the last two lines are deducted from the gross totals.

### 1. *Competition*

In cases concerning competition, the Board's decisions reflect a policy of encouraging deconcentration. It has taken its direction from the Supreme Court's opinion in *Philadelphia National Bank* that, if concentration is already great, the importance of preventing even slight increases in concentration and preserving possible deconcentration is also great. Board decisions involving existing competition (expansion within a market in which the holding company is already represented) have expressed serious concern about increasing deposit concentration and removing banking alternatives in local markets. Proposed acquisitions by dominant banking organizations in an already concentrated area are prime candidates for denials. In turning down Dominion Bankshares Corporation's application to acquire a small bank in Roanoke, Virginia, the Board noted that "although the applicant's share of market deposits would increase by only .8 percentage points consummation would aggravate the high level of deposit concentration in the market."[36] At the time of application, four banking organizations controlled eighty-five percent of local market deposits, with Dominion Bankshares' leading bank accounting for forty-three percent of total deposits in the Roanoke market. Thus, it was clearly the predominant bank in the area. In the opinion of the Board, an acquisition by a holding company of a bank outside of the market would have had a more beneficial effect upon competition.

In finding undue concentration, the Board has occasionally extended the scope of the relevant market area. In doing so, it has established a doctrine of market overlap under which existing competition is no longer confined to specific geographic lines such as standard metropolitan statistical areas. The Board ruled in *Old Kent Financial Corp.*[37] that "while Old Kent and bank are in banking markets that are regarded as separate at this time, there is some competition between them." The overlap in the instance was hardly large. The holding company obtained only $1 million of its $775 million in deposits from the proposed subsidiary's bank's market area, while the latter received $3 million of its $105 million in deposits from the locality served by the holding company subsidiary. The Board stated that approval would have raised Old Kent's deposit share in a four-county region from thirty-seven to forty-two percent, thereby making it the dominant bank in the district.

Applications have also been denied on competitive grounds when the acquiring company was not necessarily dominant

[36]Dominion Bankshares Corp., 60 FED. RES. BULL. 49 (1974).

[37]60 FED. RES. BULL. 133 (1974).

throughout the market and the proposed acquisition would not have added substantially to its deposits. In some cases, the Board has simply subdivided a concentrated market into primary service areas. The extent of existing competition has then been determined within the resultant smaller geographic confines. For example, in *First at Orlando Corp.*,[38] the holding company seeking acquisition approval already controlled the ninth largest bank in the area. This subsidiary had only two percent of market deposits. The bank to be acquired was ten miles away and accounted for three percent of area deposits. Yet, the Board found that each of these relatively small banks obtained seven percent of their deposits from each other's primary service area. The percentage was considered sufficient to constitute substantial existing competition.

The primary service concept was re-affirmed in *New England Merchants Co.*,[39] in which the acquisition of a Boston area bank, holding .8 percent market deposits, was seen as "aggravating concentration." It appeared that two branches of the applicant's sole subsidiary bank derived thirty-five and twenty-six percent respectively of their demand deposits from the primary service area of the bank to be acquired. Although the Board found that these deposits represented only a small percentage of the total deposits of the subsidiary, it noted that the combined deposits and loans of the two branches equalled seventy-eight and fifty-eight percent respectively of the loans and deposits that the bank to be acquired derived from its primary service area. Conversely, the bank to be acquired derived only five percent of its loans and deposits from the two branches' primary service areas.[40] In denying both this and the *Orlando* applications, the Board expressly preferred deconcentration via acquisitions of the banks by holding companies outside of the market.

The issue of dominance reappears in applications for the acquisition of proposed or de novo banks. In denying one Florida holding company's request for an acquisition of a yet-to-be established bank, the Board feared that adverse competitive effects were likely because the applicant's subsidiary already had nineteen percent of deposits in the local market.[41] It concluded that further offices would raise barriers to entry by other organizations and increase concentration of banking resources in the market. In another Florida denial, the Board concluded that a re-

[38] 58 FED. RES. BULL. 818 (1972).

[39] 59 FED. RES. BULL. 459 (1973).

[40] *Id.* at 459-60.

[41] General Financial Systems, Inc., 60 FED. RES. BULL. 452 (1974).

cently established bank would be hurt by the opening of yet another de novo bank in the same market.[42]

Apparently, the Board has also sought to be a deconcentrating influence by severing affiliations or maintaining the possibilities of disaffiliation. For instance, in *First International Bancshares*,[43] the applicant requested approval to acquire two banks affiliated with each other in the Houston market. The ruling allowed the company to acquire one bank, but not the other, thereby breaking up the chain. In *Texas Commerce Bancshares, Inc.*, [44] five percent of the shareholders of the applicant held sixty-five percent of the shares in a small Houston bank which the applicant sought to acquire. Moreover, there had existed a history of a close working relationship between one of the applicant's subsidiary banks and the bank to be acquired, although this relationship had declined in recent years. The Board felt that further disaffiliation was a "reasonable prospect." In its opinion, a takeover in that instance would have resulted in the loss of an independent bank in a growing market and foreclosed entry into the market by means of acquisition of another bank holding company. Only when an affiliation could be deemed permanent and little chance for de novo entry existed have such applications been approved.[45]

### *2. Potential Competition*

Many bank holding companies, denied expansion opportunities within their existing markets, have eyed acquisitions elsewhere. In denying applications for acquisitions of banks in markets where companies are not already represented, the Board has relied increasingly over the years on the factor of potential competition. In pursuit of its policy of deconcentration, the Board has tried to preserve, when possible, the acquiring bank as a source of future competition. For example, in denying the application for First International Bancshares' acquisition of Citizens First National Bank of Tyler, Texas, the Board established a doctrine barring the largest companies in the state from absorbing leading banks in secondary markets if there is the likelihood that the acquisition would reduce potential competition.[46] With this ruling—reaffirmed in the denial of First International's application to acquire the largest bank in Waco, Texas,[47] and in

[42]First at Orlando Corp., 59 FED. RES. BULL. 302 (1973).

[43]59 FED. RES. BULL. 453 (1973).

[44]58 FED. RES. BULL. 486 (1972).

[45]*See, e.g.*, First United Bancorporation, 58 FED. RES. BULL. 669 (1972); Texas Commerce Bancshares, 58 FED. RES. BULL. 908 (1972).

[46]First Int'l Bancshares, Inc., 60 FED. RES. BULL. 43 (1974).

[47]First Int'l Bancshares, Inc., 60 FED. RES. BULL. 271 (1974).

turning down the takeover of Meyerland Bank of Houston by First City Bancorporation[48]—the Board expressed its concern over the rise of concentration in the state as well as in local banking markets. In its order denying the Citizens Bank application, the Board said it did not have to await the development of undue concentration among bank holding companies to stop the trend. Taking its cue from the United States Supreme Court decision in *United States v. Brown Shoe Co.*,[49] the Board considered that it had a mandate to break the force of a trend toward undue concentration "before it gathers momentum."[50]

The Board reasoned in such cases that if one of the large companies enters a market by creating a new bank or acquiring a small bank or "toehold," additional competition will be created. But if one of these firms enters by acquiring one of the leading banks in the market, the acquisition will not amount to additional competition in the market. Either development would remove the acquiring company from the ranks of *potential* competitors. But if the company entered the market by acquiring the leader, there would be no increase in *actual* competition to offset the lessening of potential competition. Moreover, an opportunity to reduce market concentration would have been lost. The acquisition would solidify the acquired bank's market position while foreclosing the possibility of its either remaining a significant competitor or becoming affiliated with one of the smaller bank holding companies.[51]

Even a small or "toehold" acquisition may not meet with approval if the holding company is exceptionally large. Such was the case in *Northwest Bancorporation*.[52] There, the second largest banking organization in Minnesota, which controlled forty-eight banks within the state and many out-of-state subsidiaries, sought approval to acquire the smallest bank in a county, one which had only two percent of market deposits. Continuing in the vein of *Brown Shoe*, the Board stated that whether the process was a nibble or a gobble, the end result was the same—concentration.[53] It suggested that an acquisition by a smaller bank holding company would have been preferable.

It should be noted at this juncture that the United States Department of Justice has sought to extend the doctrine of potential competition even further—to mergers of banks operating in separate geographic markets which may contribute to state-

[48]First City Bancorporation, Inc., 60 FED. RES. BULL. 507 (1974).
[49]370 U.S. 294 (1962).
[50]*Id.* at 318.
[51]Stodden, *Multibank Holding Companies—Development in Texas Changes in Recent Years*, FED. RES. BANK OF DALLAS BUS. REV. 9 (Dec. 1974).
[52]59 FED. RES. BULL. 197 (1973).
[53]*Id.* at 201.

wide concentration. It has done so by challenging several applications approved by the Board.[54] But so far, success has eluded it. In *United States v. Marine Bancorporation,*[55] the Supreme Court rejected the Government's claim that a statewide linkage of oligopolies might arise and that large banks across the state might engage in more standardized behavior as a result. It held that "[i]n applying the doctrine of potential competition to commercial banking courts must . . . take into account the extensive federal and state regulation of banks."[56] Particularly, the Court noted the restraints on entry unique to this line of commerce. In the circumstances of that case, the relevant geographic market of the acquired bank was the local area in which that bank was in significant direct competition with other banks. This ruling was recently re-affirmed in *United States v. Connecticut National Bank.*[57] Again, competition was considered in terms of local banking markets. Incidentally, the Court also acknowledged that "at some stage in the development of savings banks it will be unrealistic to distinguish them from commercial banks for the purpose of the Clayton Act."[58] It would appear, therefore, that the Board has rejected applications on anticompetitive grounds that the Department of Justice would have lost in court. On the other hand, the Department has failed to have any of the Board's challenged approvals reversed. But, it should be noted that only bank mergers and holding company acquisitions have been challenged, not those of nonbank subsidiaries.

### 3. *Financial Considerations*

A growing source of Federal Reserve Board concern has been the safety of bank deposits. The turbulence which has struck the financial markets in recent months and culminated in the nation's first multi-billion dollar bank failure has brought a new caution to regulatory agencies.[59] Board Chairman Arthur Burns has let it be known that the Board is putting on the brakes as arbiter of holding company proposals for new ventures and ac-

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[54]*See, e.g.,* United States v. First Nat'l Bancorporation, 329 F. Supp. 1003 (D. Col. 1971).

[55]418 U.S. 602 (1974).

[56]*Id.* at 641.

[57]418 U.S. 656 (1974).

[58]*Id.* at 666.

[59]On October 8, 1974, Franklin National Bank of Mineola, New York, was declared insolvent by Currency Controller James E. Smith. This was the largest bank failure in American banking history. Franklin was immediately taken over by European-American Bank and Trust Company in an agreement that guaranteed no losses to any Franklin depositors. N.Y. Times, Oct. 9, 1974, at 1, col. 1.

quisitions.[60] Any company seeking Board approval for an acquisition can expect its capital position to be thoroughly scrutinized. The Board has been especially anxious about acquisition programs comprised substantially of debt capital. It feels that the borrowing capacity of the holding corporation should be reserved primarily to support the company's potential for assisting its subsidiaries. The holding company should be a source of strength, whose vitality must not be sapped by acquisitions of undercapitalized and weak banks.[61]

An applicant must be able to service the debt incurred in financing the acquisition in a reasonable and realistic manner, lest the capital position of either the proposed bank or an existing subsidiary be consequently impaired.[62] A major factor in this area is bank earnings growth rate projections. Overly-optimistic return estimates risk denial.[63] Proposed dividends that are to be used to pay off the debt must be reasonable and in line with established earnings trends. Sudden sharp increases in payouts may not be warranted in view of past bank performance.[64] Such payments are particularly suspect when the proposed bank's capital-to-assets ratio shows a declining trend.[65] Management fees may be used as a supplement to or in lieu of dividend payments, but they too cannot be relied upon when the proposed bank's capital structure is fundamentally weak.[66] Moreover, fees paid must be for actual services rendered.[67]

The Board has also made it clear that the holding company itself must be financially sound at the time of the acquisition. In *Central Bancorporation,*[68] the holding company's application was denied on the basis of declining holding company income. A stock offering to eliminate the acquisition debt was viewed as unlikely to be successful at the desired price. In *United Missouri Bancshares,*[69] approval was denied because of what the Board considered an excessive purchase price for the acquisition. The amount proposed was 200 percent of the book value of the bank to be acquired, a premium equal to 22 percent of its bank deposits. This premium was held to have a retarding effect on hold-

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[60]BURROUGHS CLEARING HOUSE, Dec., 1974, at 28.

[61]JOHNSON, *supra* note 34, at 35.

[62]Cegrove Corp., 59 FED. RES. BULL. 677 (1974).

[63]*See, e.g.,* BHCO, Inc., 60 FED. RES. BULL. 312 (1974).

[64]Aurora First Nat'l Co., 60 FED. RES. BULL. 362 (1974).

[65]*See, e.g.,* Tri-State Bancorporation, 60 FED. RES. BULL. 777 (1974); Commonwealth Bancshares, Inc., 60 FED. RES. BULL. 865 (1974).

[66]Adair Corp., 60 FED. RES. BULL. 309 (1974).

[67]North Shore Capital Corp., 60 FED. RES. BULL. 809 (1974).

[68]58 FED. RES. BULL. 833 (1972).

[69]59 FED. RES. BULL. 155 (1972).

ing company earnings. Finally, excessive holding company leverage has been a cause of denial. In *Financial Securities Corp.*,[70] a capital structure of $5,000 stockholder equity and $1.6 million debt was considered to be a clearly disproportionate level of borrowing.

### *4. Transactional Factors*

As Table I suggests, transactional factors have not been a major concern in the denials of applications. One case dealt with the need to offer equal share prices to all stockholders.[71] This requirement has since been incorporated into the delegated guidelines.[72] A more recent denial points out the problem of aggravating dissension among stockholders. In *NBC Corp.*,[73] the applicant sought a minority interest in a bank, but a majority of the bank's stockholders had expressed their opposition to this acquisition. The Board felt that the conflicts which would inevitably ensue with respect to management and dividend policies would not contribute to the financial soundness of the holding company.

## *B. Nonbank Acquisitions*

As Table II indicates, from 1971 through 1974, forty-seven orders of denial under section 4 were reported—representing about ten percent of nonbank applications to the Board.[74] The causes for denials of nonbank acquisitions have typically been the same as for bank acquisitions. Further, it is likely that the Board's practice of formally determining permissible nonbank activities has precluded some other opportunities for denial.[75]

In its consideration of bank acquisitions, the Board has scrupulously followed the *Philadelphia Bank* rule—that banking is a "unique cluster of services."[76] In nonbank cases, however, holding company activities are unbundled, and each service line is presumably considered separately. If, for example, a holding

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[70]58 FED. RES. BULL. 833 (1972).

[71]Western Bancshares, Inc., 58 FED. RES. BULL. 843 (1972).

[72]JOHNSON, *supra* note 34, at 11.

[73]60 FED. RES. BULL. 782 (1974).

[74]Jessee & Selig, *An Analysis of the Public Benefits Test of the Bank Holding Company Act*, FED. RES. BANK OF N.Y. MONTHLY REV. 151 (June 1974).

[75]There have been five proposed nonbank acquisitions denied on the grounds that the activities were not closely related to banking. *See, e.g.*, Bank America Corp., 60 FED. RES. BULL. 674 (1974).

[76]374 U.S. at 356. *See also* United States v. Phillipsburg Nat'l Bank & Trust Co., 399 U.S. 350, 359 (1974).

company seeks to acquire a mortgage lending firm, the competitive considerations should focus on the company's penetration of mortgage lending in the market involved—mortgage lending by its present subsidiary banks and nonbanks. The delegated guideline of ten percent market share of the relevant service line parallels the percentage established by the Board in bank cases.[77]

TABLE II

Nonbank Acquisitions Denied Under Section 4
of the Bank Holding Company Act of 1970

| | 1971 | 1972 | 1973 | 1974 | Total |
|---|---|---|---|---|---|
| Reason for Denial: | | | | | |
| (a) Existing Competition | | 4 | 7 | 7 | 18 |
| (b) Potential Competition | | 4 | 3 | 4 | 11 |
| (c) Regulation Y and Exceptions | 1 | 6 | 2 | 4 | 13 |
| (d) Financial Considerations | | 2 | 2 | 4 | 8 |
| (e) Transactional Factors | | 1 | 1 | 1 | 3 |
| Totals | 1 | 17 | 15 | 20 | 53 |
| Both (a) and (b) | | 2 | 1 | 1 | 4 |
| (a) and/or (b) and (d) | | 1 | | 1 | 2 |
| Adjusted totals[78] | 1 | 14 | 14 | 18 | 47 |

In practice, however, the Board has probed beyond this guideline to discourage the expansion of leading banks into related product lines in the same market where the nonbank firm is dominant. This predilection has been pronounced in Board denials of mortgage bank acquisitions. In turning down First National City Bank's acquisition of Advance Mortgage Corporation,[79] the Board called attention to the applicant's resources, which gave it the ability to enter new markets de novo or through the acquisition of a smaller firm. Concern lay with the possible adverse implications of the acquisition of the third largest mortgage lending firm in the nation by the second largest banking organization. The application was expressly denied on the grounds of reduced existing and potential competition and an undue concentration of resources. The ruling, however, was not unanimous. It met with the dissent that Advance and First National did not compete in any of the same markets for one-to-four family residential mort-

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[77]JOHNSON, *supra* note 34, at 37.

[78]To avoid double counting, the last two lines are deducted from the gross totals.

[79]60 FED. RES. BULL. 50 (1974). *See also* First Commercial Banks, Inc., 59 FED. RES. BULL. 118 (1973).

gage loans. The dissenting opinion noted that Advance accounted for less than one percent of total national originations on loans for income properties by mortgage companies and less than .3 percent of all such originations by mortgage lending institutions. Governor Sheehan chided his colleagues for ruling upon bigness per se, not concentration in particular product lines and particular markets.

Chase Manhattan's proposed acquisition of Dial Finance Corporation supplied another instance of denial on the grounds of undue concentration of credit-granting resources and the elimination of potential competition.[80] The Board declared that both Chase and Dial were capable of operating new offices and had planned to do so in the absence of the affiliation. It held that the issue of concentration in credit-granting resources was within the intent of Congress in enacting the 1970 Amendment. This opinion drew the same dissent as did the denial of First National's application.[81]

Out-of-state acquisitions have also been denied on account of size. Manufacturer's Hanover of New York had hoped to acquire a Connecticut-based mortgage firm.[82] In spite of a finding of no existing competition, the Board noted that the holding company, as the fourth largest bank in the general area, would do better to expand de novo. The Board's opinion further observed that consummation of the acquisition would have raised barriers to entry in the field.

Section 4 of the Act contains no requirement that the Board consider the financial resources of both parties in a nonbank transaction. Nevertheless, the Board has recently expressed the view that so-called "go-go" banks should now "go-slow" with expansion into new activities and should direct their energies toward strengthening existing operations, particularly when the proposed expansion would be into new activities in which the bank holding company has not been previously engaged. Moreover, when a holding company goes to the market to obtain capital, the market generally does not adequately appraise the strength of the holding company. It may assume that holding companies are as strong as their banks, which presumably are not so wont to fail because of public agency supervisory activities. Nonbanking subsidiaries, however, are less regulated and supervised. If one of them should fail, holding company management may feel obligated to use bank

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[80]Chase Manhattan Corp., 60 Fed. Res. Bull. 142 (1974). A revised acquisition proposal was also denied. *Id.* at 874.

[81]*Id.* at 145 (Governors Daane & Sheehan, dissenting).

[82]Manufacturer's Hanover Corp., 59 Fed. Res. Bull. 532 (1974).

assets to protect holding company integrity.[83] In recently denying the American Fletcher Corporation's acquisition of a savings and loan company in Arizona,[84] the Board noted that the holding company had recently acquired four other nonbank organizations. It said that resources should not be carried away from the possible future needs of subsidiary banks.

The Board's denial of Chemical New York Corporation's application to acquire CNA Nuclear Leasing came as no surprise.[85] CNA had a debt-equity ratio of seventy-four to one, and it would have required heavy financing to meet long-term growth objectives. An affiliation would have required Chemical to increase its short-term borrowings substantially, possibly sapping the financial strength of the holding company. In its order the Board maintained that "one of the primary purposes of a holding company is to serve as a source of strength for its subsidiary banks."[86] The acquisition would have reduced Chemical's ability to supply capital to its banks in the future. In a later instance, the Board denied a leasing acquisition on grounds that additional funds should be used to strengthen the bank rather than support leasing activities.[87] The acquisition would have detracted from the bank holding company's overall financial position and would have reduced its ability to provide additional support to subsidiary banks.

Other financial tests applied by the Board have been similar to those discussed in section 3 applications. Projected earnings must be realistic and sufficient to meet acquisition debt.[88] The holding company must be financially sound at the time of acquisition.[89] It must not be excessively leveraged.[90] The same course has been followed with respect to the transactions criterion. The only aspect so far unique to nonbank acquisitions has been the matter of post-employment contracts. Such covenants, if unreasonably restrictive, have been cited by the Board as anticompetitive.[91]

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[83] *See* Greenspan, *Bank Holding Companies: Competition, Capital, and Non-banking Acquisitions*, 90 BANKING L.J. 560, 574 (1973).

[84] American Fletcher Corp., 60 FED. RES. BULL. 868 (1974) .

[85] Chemical New York Corp., 59 FED. RES. BULL. 698 (1973).

[86] *Id.* at 699.

[87] Bankshares of Indiana, Inc., 60 FED. RES. BULL. 872 (1974).

[88] Farmers State Corp., 60 FED. RES. BULL. 787 (1974).

[89] UB Financial Corp., 60 FED. RES. BULL. 791 (1974). *See also* Franklin Nat'l Corp., 60 FED. RES. BULL. 458 (1974).

[90] Bezanson Investments, Inc., 58 FED. RES. BULL. 835 (1972).

[91] Manufacturer's Hanover Corp., 59 FED. RES. BULL. 908 (1973). For a further discussion of the Board's view on covenants not to compete, see Citizens & Southern Nat'l Bank, 60 FED. RES. BULL. 136 (1974).

## IV. Concluding Observations

In carrying out its responsibility under the Bank Holding Company Act, the Board has actively sought to preserve competition and maintain a sound banking structure. It has done so, however, with diligence and caution, in the interest of maintaining a degree of flexibility. The delegated guidelines are merely general and noncontroversial indicators of concern, leaving the Board free to formulate many policies on a case-by-case basis.

Board classification of nonbanking activities under Regulation Y has been likened to the serpentine wall which Thomas Jefferson built at Charlottesville, Virginia.[92] The start was conventional enough, limiting approved activities to those traditionally associated with the intermediation process of getting money in and lending money out. The first jog in the wall came on the issue of certain computer services, and it was an appropriate line of departure for the last third of the twentieth century. Thereafter, the wall has wound one way and then another. Finance companies are in, but savings and loan associations are currently out. Investment advice is in, while management consulting for affiliates is out. The insurance business is partly in and partly out. In viewing the zigs and zags of the wall, it becomes difficult to perceive an abstract principle of architecture underlying the whole.

What can be said about the trend of Board case decisions? First of all, there appears to be an essential fusion of sections 3 and 4 with an ongoing homogenization of standards applicable to both bank and nonbank expansion. Second, lying beneath the aggregate decisions is a coherent set of principles of adjudication: competition and concentration, capital adequacy, and conflict of interest. Third, the Board has applied principles established by the courts in nonbanking cases to the holding company system at large.

In particular, it will be very difficult for a bank holding company whose lead bank can in any manner be considered among the dominant in a market to acquire a major bank subsidiary. Nor will leading bank organizations in a state find it easy to acquire a leading bank in the same state, even if that bank is outside the market area currently served by the holding company. Entrance de novo or through "toehold" acquisitions of smaller banks is to be encouraged. The Board has also recognized that expansion of leading banks into related product lines in the same geographic area where the bank is dominant can raise serious competitive questions. Moreover, *both* the holding company and

[92]Johnson, *supra* note 34, at 21.

the proposed subsidiary must be in sound financial health. Acquisition debt must not jeopardize the holding company's position as a source of strength.

Yet, within these wide limits, the path of Board interpretations may be as sinuous as the Jeffersonian wall. No hard and fast line has been drawn in case opinions about the precise degree of concentration or percentage of market deposits that would definitely rule out proposed acquisitions. Small percentage holdings may be sufficient in one case, though not in other circumstances. Neither has the concept of reasonable capital adequacy been spelled out. Excessive leverage has been measured only in extreme cases. The Board takes many features into consideration in its deliberations—existing state legal constraints, the degree of concentration within a state as well as in local markets, future projections for banking areas, the current state of the economy, and management practices of financial institutions. What may be cause for approval in one case may not be so for a similar case in another state or another period of time. This practice may prove a blessing or a bane. Perhaps flexibility has been necessary in order to meet new situations.

The Board's task, as reshaper of the legal milieu in the banking industry, is not without problems. One of the major problems confronting the Board in attempting to preserve competition in banking is that Congress failed to provide it with clear guidelines as to what constitutes undue concentration. A few state legislatures have established concentration guidelines. For example, deposit concentration in one holding company system in Missouri is limited to thirteen percent of deposits[93] and in Iowa to eight percent.[94] In most states where holding companies are permitted, there are no specific limits.

Furthermore, the preservation of competition represents a change in the purposes of bank regulation. During most of the history of banking in the United States, the principal consideration in chartering and regulating banks has been to establish and preserve strong viable institutions. For this reason, entry into banking has been and still is restricted. To obtain a bank charter, it is necessary for the applicants to demonstrate that a new bank is needed and that it is likely to operate profitably. Free entry is a mark of pure competition which does not exist in banking.

A study made by the Federal Deposit Insurance Company in 1960 revealed that as of June 30, 1958, there were 7,703 bank-

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[93]Mo. H.R. No. 1798, Gen. Assembly, 2d Reg. Sess. (1974) (Mo. Ann. Stat., App. Pamphlet, Vernon's 1975).

[94]Iowa Code § 524.1802 (Supp. 1974).

ing offices in population centers having only one banking office.[95] It is unlikely that this situation has changed greatly. In any event, one-bank population centers are more nearly comparable to an economic monopoly rather than to pure competition. In population centers with more than one banking office, the form of competition is more oligopolistic in nature than one of pure competition. Oligopolistic competition in banking is largely of a nonprice variety; it is typified by product differentiation, such as the use of logos, or by the services offered. This is not to imply that the preservation of an alternative banking choice is undesirable. It does, however, indicate the problem confronted by the Board of Governors in preserving competition in an industry that is not marked by free entry and price competition. In promoting service competition, a balanced system of branching may be superior to the holding company alternative.

It is difficult to predict the future with precision. Current and projected developments in finance and funds transfer may render the Court's rationale in *Philadelphia Bank* obsolete; that is, banking may lose its "unique" characteristic. This was hinted at in the 1974 *Connecticut Bank* decision. Savings and loan associations, mutual savings banks, and credit unions are demanding a role in third-party transfers and in an electronic funds transfer system. The bridge has been crossed in two states, New Hampshire and Massachusetts, where mutual savings banks are permitted to utilize third party funds transfers, known as negotiable orders of withdrawal. This development gives mutual savings banks personal deposit accounts that are directly competitive with commercial bank checking accounts. Thrift institutions have received some liberalization in the span of their lending authority and are seeking to broaden their authority still further. There is an erosion in the wall that makes commercial banking unique when compared with nonbank financial institutions. Ultimately Congress must establish new guidelines for evaluating competition and, hopefully, at such a time, it should consider just how much concentration of financial resources is necessary or desirable and what, if any, geographical limits should be imposed.

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[95]1960 FDIC Ann. Rep. 47-48.

# The Impact of Courts on Society: Residency Requirements for Welfare Benefits As a Case Study

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## I. INTRODUCTION

Legal scholars have evidenced a widespread interest in examining the impact of courts upon the social system.[1] Although there is considerable difficulty in isolating and measuring a law's impact,[2] many of the efforts to date have been encouraging.[3] A key finding in this impact research is that court decisions have varying effects. This suggests that a mechanistic view of legal impact is inaccurate. Change in society is not easily brought about by change in the law.[4]

The elimination of durational residency requirements[5] for the receipt of welfare assistance in Illinois affords an excellent opportunity to examine the above thesis. The importance of wel-

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[1]One of the most recent and comprehensive studies of this nature is S. WASBY, THE IMPACT OF THE UNITED STATES SUPREME COURT: SOME PERSPECTIVES (1970).

[2]*See* Feeley, *Power, Impact, and the Supreme Court*, in THE IMPACT OF SUPREME COURT DECISIONS 218-29 (2d ed. 1973).

[3]*See* C. SHELDON, THE AMERICAN JUDICIAL PROCESS: MODELS AND APPROACHES 127-63 (1974).

[4]Stumpf & Turpen, *Law, Poverty and Change*, 2 POLICY STUDIES J. 195 (1974).

[5]Residency requirement elimination is a particularly useful area for impact study since the data allow for a comparison of migration both before and after its occurrence. In addition, the data are found in a time series rather than only at one point in time. Time series data are very rare in research concerning the impact of a change in the law. *See* SHELDON, *supra* note 3, at 160-61.

fare residency requirement decisions is underscored by one of the leading legal impact scholars, Stephen L. Wasby. In a recent article on welfare law, Wasby states that the elimination of residency requirements could be considered one of the most significant welfare law decisions.[6] In Illinois, durational residency requirements were declared unconstitutional in *Johnson v. Robinson.*[7] *Johnson* was one of several cases striking down residency requirements and its result was affirmed by the United States Supreme Court in *Shapiro v. Thompson.*[8] In *Shapiro*, the Supreme Court held that the imposition of durational residency requirements for the purpose of inhibiting migration of indigents into a state constituted a constitutionally impermissible restriction of the right to travel[9] and established invidious discrimination which denied equal protection.[10] This decision has been the focus of criticism by state and local governmental officials ever since it was handed down in 1969. Officials of state governments have argued that without residency requirements the fiscal integrity of states offering relatively high welfare payments would be jeopardized. They have expressed fear that without residency requirements those urban, industrial states with high benefits would be swamped by an influx of needy persons seeking higher levels of welfare benefits.

For example, Vice-President Rockefeller, as Governor of New York, argued that the absence of residency requirements would precipitate the migration of low income individuals to New York from states with lower paying welfare programs.[11] Robert H. Finch, who was Secretary of the Department of Health, Education, and Welfare when *Shapiro* was decided, predicted that the decision would make national welfare standards "inevitable."[12] He added that: "To say that [*Shapiro*] will have a substantial impact on federal and state budgets is a massive understatement."[13] The New York City Commissioner of Social Services argued that the city received a disproportionate share of the nation's welfare burden because it did not have a durational residency requirement.[14] An Associated Press survey of welfare directors in states that had durational residency requirements prior to *Shapiro* found widespread concern that the decision would spur

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[6]Wasby, *The Supreme Court as Enunciator of Welfare Policy,* 2 POLICY STUDIES J. 205 (1974).

[7]296 F. Supp. 1165 (N.D. Ill. 1967), *aff'd,* 394 U.S. 847 (1969).

[8]394 U.S. 618 (1969).

[9]*Id.* at 634.

[10]*Id.* at 627.

[11]N.Y. Times, Jan. 30, 1969, at 20, col. 4.

[12]N.Y. Times, Apr. 22, 1969, at 1, cols. 6-7.

[13]*Id.*

[14]*Id.* at 22, cols. 7-8.

increased migration of the poor from low-benefit to high-benefit states.[15]

The same arguments have continually been advanced and have been paralleled by legislation.[16] New York, for example, enacted into law a one-year residency requirement which was to be effective for a five-year "emergency period" after the state's administration had argued that such a requirement was essential to the state's "economic and social viability."[17] This statute was enjoined after it had been in force only one month, and later it was declared unconstitutional.[18] The district court refused to accept the state's argument that a "compelling governmental interest" was involved. A similar bill was approved overwhelmingly by the Illinois General Assembly,[19] although it subsequently was vetoed by the state's governor, who doubted its constitutionality.[20] Similar efforts in other states, when successfully enacted into law, also have been struck down by the courts.[21]

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[15] *Id.*

[16] *See, e.g.*, NEWSWEEK, July 26, 1971, at 31; N.Y. Times, June 9, 1971, at 1, col. 5; *id.*, June 24, 1971, at 27, cols. 2-5.

[17] N.Y. Acts of 1971, ch. 606.

[18] Lopez v. Wyman, 329 F. Supp. 483 (W.D.N.Y. 1971), *aff'd*, 404 U.S. 1055 (1972). A temporary injunction was granted on July 12, 1971, until the cause could be heard by a three-judge court. On August 9, 1971, the three-judge court found the statute in violation of the equal protection clause of the fourteenth amendment and permanently enjoined enforcement. The Supreme Court affirmed without opinion.

[19] Ill. S. 1225, 77th Gen. Assembly, 1st Sess. (1971) (passed in the Senate 51 to 4 and in the House 111 to 45).

[20] 1 *1971 Final Legislative Synopsis and Digest of the Seventy-Seventh General Assembly, First Session* 451. The governor's veto was overridden in the Senate, but similar efforts in the House failed. *Id.*

[21] CONN. GEN. STAT. ANN. § 17-82p (Supp. 1974) established a five-year emergency period during which the state would require a one-year residency for eligibility for public assistance and care. The residency requirement could not be justified on the basis of economy and was held unconstitutional on its face. Rivera v. Dunn, 329 F. Supp. 554 (D. Conn. 1971), *aff'd*, 404 U.S. 1054 (1972).

A Rhode Island statute which denied public assistance of any kind to persons who had not resided in the state for at least one year was declared unconstitutional as violative of the fourteenth amendment to the United States Constitution, notwithstanding a legislative finding that the requirement was based on economic factors. Besaw v. Affleck, 1 CCH 1972 POV. L. REP. ¶ 1115.303 (D.R.I. Nov. 11, 1971).

In Massachusetts an advisory opinion by the Massachusetts Supreme Judicial Court held that enactment of a bill to establish a one-year residency requirement with a preamble setting forth emergency reasons for the enactment would violate the fourteenth amendment to the United States Constitution. Opinion of Justices to House of Representatives (Mass. 1971).

The Oregon Attorney General entered an opinion stating that imposition of a residency requirement of less than one year would violate the Supreme

Officials who favor durational residency requirements appear to rely on an implicit set of propositions about human behavior which would include the following:

(1) There is a direct, causal relationship between the level of welfare payments in a state and the direction of migration by indigents such that the latter move from low-payment to high-payment states to receive higher welfare payments.

(2) The use of durational residency requirements discourages migration by indigents to high welfare benefit states.

## II. An Empirical Examination of the Effect of Residency Requirements

While it seems doubtful that residency requirements will be successfully reinstituted, it remains important to understand what the effects of residency requirements were. Negative consequences attend the failure to answer the question of whether the elimination of durational residency requirements actually resulted in a burden on the welfare systems of certain states. These negative consequences include (1) lack of knowledge of the effect of law upon society, (2) lack of an appreciation of the complexity and dynamics of law, and (3) continued confusion regarding the validity of arguments that residency requirements are useful tools of welfare administration.[22] In order to test the effects of residency requirements, the Illinois welfare program is used as a case study. Illinois is a large industrial state with high welfare benefits in comparison to neighboring states, so it should be an ideal unit for a residency requirement impact study.[23]

If residency requirements have an impact on migration, one would expect that the proportion of Illinois' welfare recipients with less than one year's residency before receiving benefits would have increased after the removal of the state's durational residency requirement in February of 1968.[24] This conclusion

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Court's holding in Shapiro v. Thompson, 394 U.S. 618 (1969). Ore. Att'y Gen. Op. 6638 (1969).

[22]In the spring of 1972 the authors mailed a questionnaire to each of Illinois' 101 welfare supervisors. Seventy of the supervisors returned the questionnaire. Fifty-six percent of the respondents agreed that some type of durational residency requirement is "absolutely necessary for the effective administration of welfare funds." Only thirty-one percent of the respondents believed that a durational residency test is "a useless tool for the administration of welfare benefits."

[23]*See generally* Illinois Institute for Social Policy, Welfare in Illinois: A Background Report (1972).

[24]Illinois was enjoined by the United States District Court for the Northern District from enforcing any residency requirements in its welfare

follows since only potential migrants, not current residents of Illinois, would have been discouraged by the durational residency requirement from seeking welfare benefits. Thus, once the disincentive was removed, migration should have increased, resulting in an increase in the proportion of migrant welfare recipients to non-migrant recipients.

In order to test this aspect of residency requirement impact, data were obtained for Illinois' two major welfare programs, Aid to Dependent Children (ADC) and Aid to the Aged, Blind and Disabled (AABD).[25] Data from June 1965 to June 1972 were used. This time frame was selected in order to provide a quasi-experimental time series analysis. This type of time series analysis is desirable since results of such a design are more trustworthy than results of a traditional after-the-fact impact analysis.[26] In addition, the choice of such a time frame is particularly desirable for this study for two reasons. First, it is well known that there tends to be a lag time between an initial decision to migrate and actual migration.[27] While it commonly has been believed that migration would occur immediately after the elimination of residency requirements, further reflection suggests that some time lag would occur. Since a time lag in the decision to migrate is often a matter of months rather than years,[28] a time series analysis which covers four years after the elimination of residency requirements should detect a lag time in the decision to migrate. Secondly, in measuring the effect of an event, it becomes more difficult to control for outside influences as the time from the event increases. One can be more certain that the impact of an event being measured is an accurate measure of impact

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programs after February 13, 1968. Johnson v. Robinson, 269 F. Supp. 1165 (N.D. Ill. 1967), *aff'd*, 394 U.S. 847 (1969). See note 7 *supra* and accompanying text.

[25]These data were abstracted from yearly summaries prepared by the Illinois Department of Public Aid. Overlapping two-year categories are utilized in Figures 1 and 2 and in Table 2 so that these data can be compared for periods before and after the elimination of the state's durational residency requirement. At the time Illinois' durational residency requirement was removed, only Illinois and New York provided benefits which met 100 percent of the basic needs of a family of four. California was providing 91 percent of these needs. U.S. NEWS AND WORLD REPORT, May 5, 1969, at 33.

[26]D. CAMPBELL & J. STANLEY, EXPERIMENTAL AND QUASI-EXPERIMENTAL DESIGNS FOR RESEARCH 37-43 (1966).

[27]Greenwood, *Lagged Response in the Decision to Migrate*, 10 J. REGIONAL SCI. 375 (1970).

[28]ABT CORPORATION, THE CAUSES OF RURAL TO URBAN MIGRATION AMONG THE POOR 22-35 (1970).

if one can measure immediately after the event.[29] For this reason, measurement of the impact of durational residency requirements stops with 1972. Measurement after 1972 could be made, though there is no theoretical reason to believe the findings would be different from pre-1972 findings. Lag time has already been accounted for in the period measured which ends in 1972. In a methodological sense, the determination of causation becomes more tenuous for each time period after the elimination of residency requirements. Thus, even by the time period of June 1971 through June 1972, the determination that residency requirement elimination has caused migration is subject to considerable debate and criticism. The link of causation between residency requirement elimination and migration would be extremely weak in later time periods.[30]

Table 1 shows that during the period from June 1965 to June 1972 there was a statewide average yearly increase of 19.3 percent in the number of ADC cases, with only the 1966 data evidencing a decrease in either the entire state's or Cook County's total caseload.[31] The number of AABD cases, however, substantially increased only during 1971 and 1972.[32]

Notwithstanding the overall increases in the absolute number of ADC cases from 1965 to 1972, Figure 1 shows that the

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[29]Campbell & Stanley, *supra* note 26, at 37-43; Sheldon, *supra* note 3, at 160-61; Wasby, *supra* note 1, at 41-42; Levine, *Methodological Concerns in Studying Supreme Court Efficacy*, 4 Law & Soc'y Rev. 589-90 (1970). For a general discussion of method, see S. Nagel, The Legal Process From a Behavioral Perspective 12-28 (1969).

[30]See authorities cited at note 29 *supra*.

[31]The categories presented are for ADC "combined cases," which are ADC cases receiving both assistance and medical care, and likewise for AABD cases eligible to receive both assistance and medical care. The theoretical justification for use of these categories is based upon the migration literature which suggests that migrants are full-fledged poor persons, rather than people merely seeking medical care.

[32]The increase in the total costs of welfare in Illinois has been substantial. If all ADC expenditures and expenditures for medical care are included, the cost figures are as follows:

| *Year* | *Total State ADC Expenditures* | *Cook County ADC Expenditures* |
|---|---|---|
| 1963 | $140,849,668 | $105,025,188 |
| 1964 | 133,238,192 | 99,488,691 |
| 1965 | 140,649,229 | 104,210,746 |
| 1966 | 143,678,106 | 106,168,048 |
| 1967 | 152,809,612 | 113,680,676 |
| 1968 | 190,681,910 | 140,954,954 |
| 1969 | 240,671,726 | 179,509,698 |
| 1970 | 311,724,620 | 232,516,074 |
| 1971 | 476,556,598 | 350,216,165 |
| 1972 | 652,651,349 | 484,496,947 |

percentage of ADC recipients who have migrated to Illinois and have become welfare recipients within one year of their migration to the state has remained remarkably constant, both for the state as a whole and for Cook County alone. Migrants represented 3.2 percent of total recipients statewide for the period from June 1964 to June 1966, two years prior to the elimination of Illinois' one-year durational residency requirement. This is the same percentage which resulted for the latest time period of June 1970 through June 1972. Cook County, when considered separately for these two time periods, represented an increase of only 0.3 percent in the number of in-migrants. The latter figure is especially important because many critics of the *Shapiro* decision believed that, if an in-migration occurred, it would disproportionately be an in-migration to metropolitan areas such as Chicago.[33] The Cook County figures suggest otherwise, showing increases and decreases in the percentage of in-migrants which closely parallel those for the entire state, except for the most recent time period of June 1970 to June 1972. Figure 1 shows that in-migration into Cook County rose one half of one percent during that two-year period, whereas statewide in-migration decreased slightly. Neither set of data provides much support for those who would predict that the courts have had an impact on migration by eliminating residency requirements. Believers in a significant court impact would have predicted a sharp increase in the percentage of migrant welfare recipients. Although both Cook County and the entire State of Illinois experienced incremental increases of 1.1 percent or less during the first three of the four time periods after the elimination of durational residency requirements, only the statewide percentage ever exceeded

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The increases in AABD expenditures are also significant:

| *Year* | *Total State AABD Expenditures* | *Cook County AABD Expenditures* |
|---|---|---|
| 1963 | $100,694,319 | $ 57,203,878 |
| 1964 | 96,974,641 | 54,801,081 |
| 1965 | 101,148,261 | 56,821,290 |
| 1966 | 113,817,940 | 61,872,434 |
| 1967 | 116,013,960 | 63,720,962 |
| 1968 | 165,411,897 | 77,748,853 |
| 1969 | 188,858,757 | 94,006,523 |
| 1970 | 199,957,913 | 108,169,605 |
| 1971 | 261,843,063 | 146,773,047 |
| 1972 | 356,020,590 | 220,517,750 |

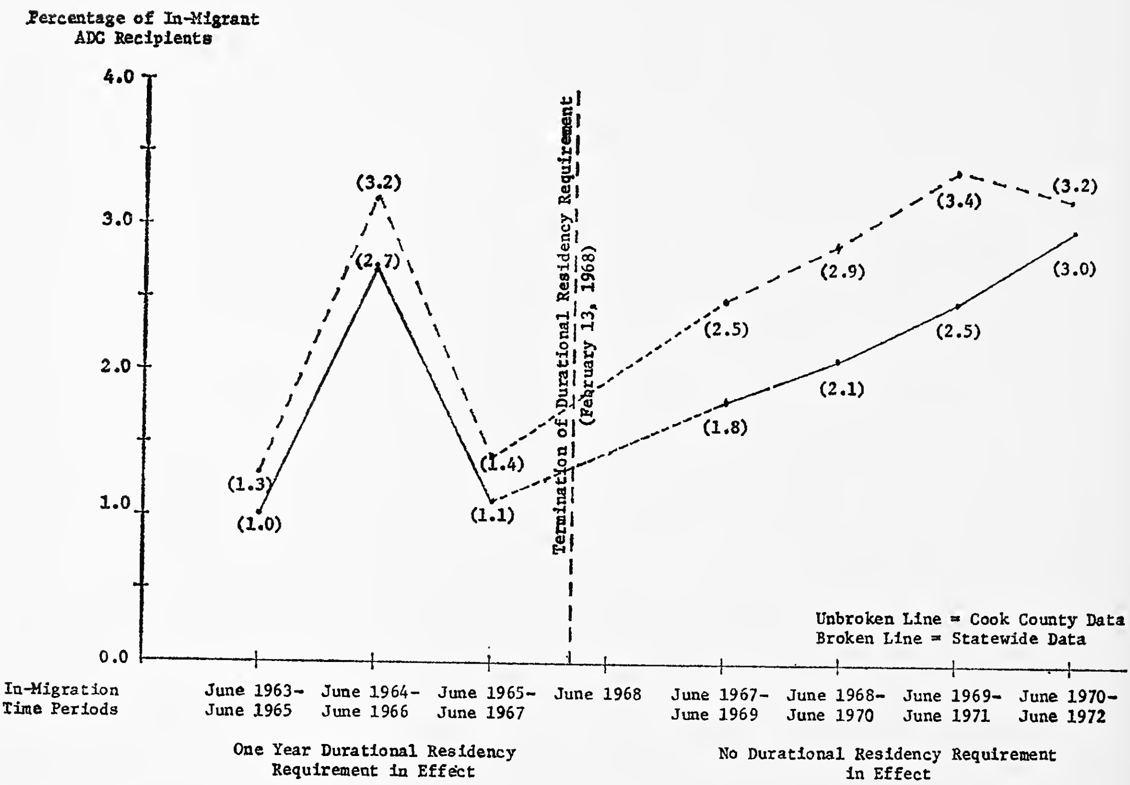
Data supplied by Illinois Department of Public Aid.

[33]Migration patterns have tended to be to the most urbanized areas of a state. *See* G. Groh, The Black Migration: The Journey to Urban America (1972).

the highest pre-elimination percentage from June 1964 to June 1966, and then only by 0.2 percent.

Figure 1

Percentage of Migrant ADC Recipients for Illinois and Cook County
*Before and After* the Elimination of Illinois' Durational Residency Requirement




Interestingly, in regard to the June 1964 to June 1966 time frame, there is no known reason for the increase in in-migration. One Illinois welfare official asserted that the increase was likely a random one.[34] If this thesis is correct, it follows that all increases in in-migration after the elimination of residency requirements might be random or at least the result of broad social and economic patterns not attributable to the elimination of residency requirements.

Similar data for AABD, shown in Figure 2, even more sharply contradict the view of significant court impact. Figure 2 shows that, in fact, a slight decrease in the percentage of migrant AABD recipients occurred, both statewide and for Cook County alone, after the elimination of Illinois' durational residency requirement. During the three most recent post-elimination measures, this percentage has risen an average of 0.7 percent per year, suggesting

[34]Telephone interview with Mr. David Keil, Bureau of Research and Statistics, Illinois Department of Public Aid, Springfield, Illinois, August 2, 1974.

that an in-migration may have occurred during those time periods. But whether this increase can be attributed solely to an absence of a durational residency requirement is questionable in view of the initial decrease which occurred during the first two-year post-elimination measures.[35]

Figure 2

Percentage of Migrant AABD Recipients for Illinois and Cook County
*Before and After* the Elimination of Illinois' Durational Residency Requirement

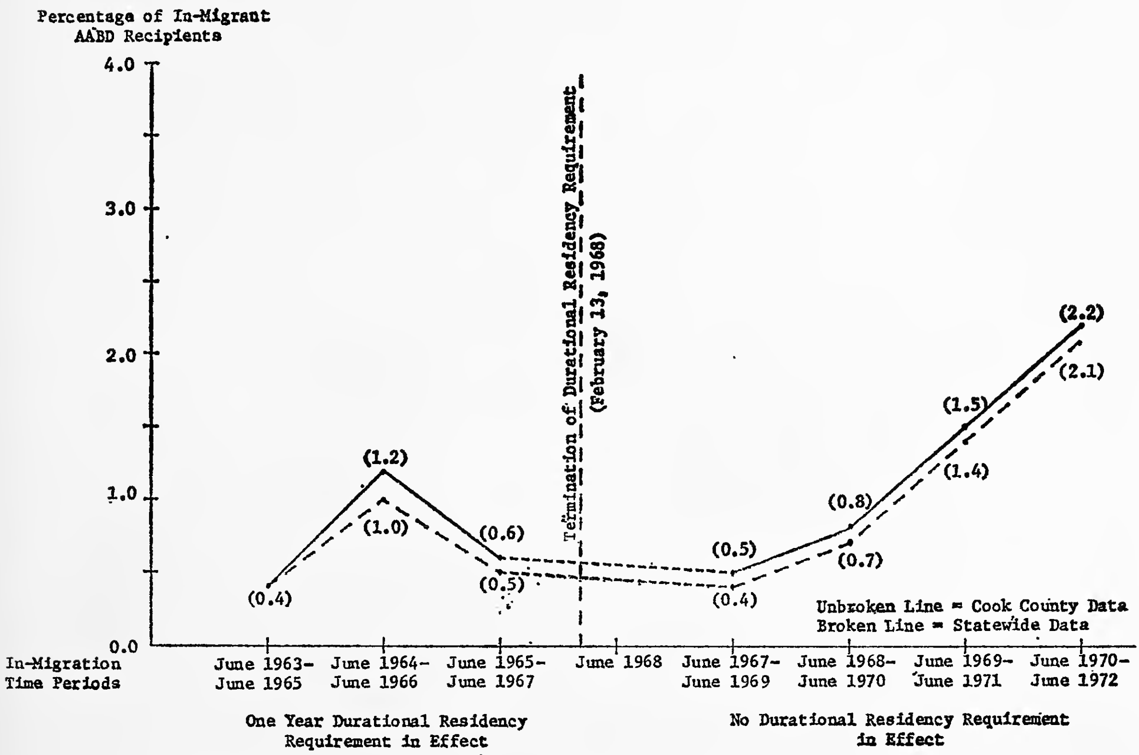



Table 2 provides particularly useful information on the migration impact of the elimination of durational residency requirements. It shows that even if the slight increases in migration proportions depicted in Figures 1 and 2 are attributed solely to the elimination of residency requirements, the decision has had little effect on increased migration. Of course, Illinois' in-migra-

[35]The possibility of error caused by the absence of a control group with which to make this determination is partly obviated here by the utilization of three before and four after measures, thus diminishing the likelihood that the results were produced by intervening variables. For comments on the weaknesses and strengths of designs such as the one presented here, see Campbell & Ross, *The Connecticut Crackdown on Speeding: Time-Series Data in Quasi-Experimental Analysis*, 3 LAW & SOC'Y REV. 33 (1968); Lempert, *Strategies of Research Design in the Legal Impact Study: The Control of Plausible Rival Hypotheses*, 1 LAW & SOC'Y REV. 111 (1966); Ross, *The British Law on Drinking and Driving*, 60 A.B.A.J. 694 (1974). *See also* CAMPBELL & STANLEY, *supra* note 26, at 37-43.

tion might best be explained as migration for purposes other than merely obtaining higher welfare benefits.[36] Thus, an attribution of all migration to residency requirements is particularly striking because, even then, only a slight impact is shown.

If one assumes that in-migration should remain at a steady level both before and after the elimination of residency requirements, the average percentage of in-migrants prior to the elimination of residency requirements can be used as an estimate of the percentage of in-migrants after the elimination of residency requirements. Thus, for state-wide ADC, one might expect 1.97% of the post-residency requirement elimination recipients to be in-migrants. The actual percentages for each post-residency requirement elimination two-year time frame were 2.5%, 2.9%, 3.4%, and 3.2%. These figures suggest some increase in in-migration after the elimination of residency requirements, but the absolute differences between the actual migration figures and the migration figures which were estimated from the pre-residency requirement elimination are small. For the two-year period from 1967 through 1969, the total statewide ADC increase in in-migration which can be attributed to residency requirement elimination was only 738 persons or .5% of total cases for that time period. For 1968 through 1970, the total statewide ADC increase in in-migration was 1,583 (.9% of total cases). For 1969 through 1971, the ADC statewide increase was 3,428 (1.4% of total cases), and for 1970 through 1972, the ADC statewide increase was 3,950 (1.2% of total cases). At most, the elimination of residency requirements can account for an average increase in ADC statewide migration of only about 1% of total ADC recipients.

Table 2 presents similar figures showing that the elimination of residency requirements can account for only a small percentage of total migration to Cook County for ADC benefits. A maximum of .2% (200 persons) to 1.4% (3,227 persons) of total Cook County cases could be said to have migrated due to residency requirement elimination. The average percentage of recipients for Cook County which may be attributable to residency requirement elimination is .8% of all Cook County's ADC recipients.

Table 2 also shows that for AABD the percentage of total recipients who may have migrated as a result of residency requirement elimination is small. Indeed, for the statewide AABD recipients, there were 341 fewer migrants to Illinois than might

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[36]Note, *Durational Residency Requirements and the Mass Migration Theory: Getting to the Heart of the Current Welfare Dilemma,* 11 Wm. & Mary L. Rev. 472 (1969). *See also* DeJong & Donnelly, *Public Welfare and Migration,* Social Sci. Q. 329 (1973).

be estimated from the average percentage of in-migrants prior to the elimination of residency requirements. In the three other two-year periods, a maximum of .1% to 1.5% of statewide AABD cases may have migrated due to residency requirement elimination.

For Cook County AABD migration, 192 fewer persons migrated than was estimated by the pre-residency requirement elimination average of in-migrants. A maximum of between .1% (63 persons) and 1.5% (2,004 persons) of total AABD Cook County cases may have migrated as a result of residency requirement elimination.

## III. Conclusions

The actual impact of the elimination of Illinois' durational residency requirement upon in-migration has been slight. No sudden upsurge of in-migration occurred in Illinois after the elimination of the durational residency requirement in February, 1968. In-migration, to the extent that it has occurred, may likely be the result of a variety of factors, particularly the economic prosperity of the state.[37] Even if the entire increase in welfare migration could be attributed to the elimination of the state's durational residency requirement, this increase does not appear great enough to support the commonly held view that the "welfare crisis" is a direct consequence of the elimination of durational residency requirements.[38]

It is noteworthy that the resultant gap between the facts and the myth of welfare migration in Illinois has resulted in legislation which the former Governor of Illinois believed was contrary to the Federal Constitution. Consequently, it is hoped that this research will engender further studies to assess the impact of law on society. Only when the myths and realities of the impact of laws are laid bare can lawmakers confidently develop laws which are relevant to societal needs.

Only further research on the impact of law can fully examine the impact of law on society, but this research must close with a disturbing note. *Shapiro v. Thompson* was viewed as a major victory for law reformers.[39] Yet the effect of the decision on migration of poor persons was minimal. This research strongly suggests that law is not necessarily a major cause of societal change. Human migration at least does not significantly depend on legislation which places economic obstacles in the path of poor migrants. Behavior is instead much more complex than the commonly held notion that change in law causes change in behavior.

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[37]See authorities cited note 36 *supra*.

[38]See authorities cited note 36 *supra*.

[39]Wasby, *supra* note 6, at 205-10.

# Appendix

Table 1 Number of ADC and AABD Cases in Illinois 1965-1972*

| | *ADC Cases Statewide* | *Percentage Change* | *ADC Cases Cook County* | *Percentage Change* |
|---|---|---|---|---|
| June 1965 | 55,014 | —— | 38,795 | —— |
| June 1966 | 52,238 | (5.0%) | 37,201 | 4.1% |
| June 1967 | 54,083 | 3.5% | 38,740 | (4.1%) |
| June 1968 | 64,112 | 18.6% | 46,026 | 18.8% |
| June 1969 | 75,187 | 17.3% | 54,167 | 17.7% |
| June 1970 | 95,099 | 26.5% | 67,579 | 24.8% |
| June 1971 | 144,604 | 52.1% | 103,415 | 53.0% |
| June 1972 | 176,598 | 22.1% | 127,044 | 22.8% |

| | *AABD Cases Statewide* | *Percentage Change* | *AABD Cases Cook County* | *Percentage Change* |
|---|---|---|---|---|
| June 1965 | 86,636 | —— | 46,425 | —— |
| June 1966 | 74,515 | (14.0%) | 41,026 | (11.6%) |
| June 1967 | 70,933 | ( 4.8%) | 39,640 | ( 3.4%) |
| June 1968 | 72,652 | 2.4% | 40,773 | 2.9% |
| June 1969 | 75,629 | 4.1% | 42,643 | 4.6% |
| June 1970 | 80,787 | 6.8% | 46,172 | 8.3% |
| June 1971 | 92,592 | 14.6% | 58,456 | 26.6% |
| June 1972 | 113,732 | 22.8% | 77,915 | 33.3% |

*Source: Illinois Department of Public Aid, Springfield, Illinois
( ) denotes negative

Table 2 Absolute and Estimated Migration in Illinois **

| *Statewide ADC* | 1967-69 | 1968-70 | 1969-71 | 1970-72 |
|---|---|---|---|---|
| Total cases | 139,299 | 170,286 | 239,703 | 321,202 |
| Actual % in-migration | 2.5% | 2.9% | 3.4% | 3.2% |
| Estimated % in-migration | 1.97% | 1.97% | 1.97% | 1.97% |
| Actual in-migration | 3,482 | 4,938 | 8,150 | 10,278 |
| Estimated in-migration | 2,744 | 3,355 | 4,722 | 6,328 |
| Difference between actual and estimated in-migration | 738 | 1,583 | 3,428 | 3,950 |
| Difference between actual and estimated in-migration as a percentage of total cases | .5% | .9% | 1.4% | 1.2% |
| *Cook County ADC* | | | | |
| Total cases | 100,193 | 121,746 | 170,994 | 230,459 |
| Actual % in-migration | 1.8% | 2.1% | 2.5% | 3.0% |
| Estimated % in-migration | 1.6% | 1.6% | 1.6% | 1.6% |
| Actual in-migration | 1,803 | 2,557 | 4,275 | 6,914 |
| Estimated in-migration | 1,603 | 1,948 | 2,736 | 3,687 |
| Difference between actual and estimated in-migration | 200 | 609 | 1,539 | 3,227 |
| Difference between actual and estimated in-migration as a percentage of total cases | .2% | .5% | .9% | 1.4% |

| | | | | |
|---|---|---|---|---|
| *Statewide AABD* | | | | |
| Total cases | 148,281 | 156,416 | 173,379 | 206,324 |
| Actual % in-migration | .4% | .7% | 1.4% | 2.1% |
| Estimated % in-migration | .63% | .63% | .63% | .63% |
| Actual in-migration | 593 | 1,095 | 2,427 | 4,333 |
| Estimated in-migration | 934 | 985 | 1,092 | 1,300 |
| Difference between actual and estimated in-migration | (341) | 110 | 1,335 | 3,033 |
| Difference between actual and estimated in-migration as a percentage of total cases | (.2%) | .1% | .8% | 1.5% |
| *Cook County AABD* | | | | |
| Total cases | 83,416 | 88,815 | 104,628 | 136,371 |
| Actual % in-migration | .5% | .8% | 1.5% | 2.2% |
| Estimated % in-migration | .73% | .73% | .73% | .73% |
| Actual in-migration | 417 | 711 | 1,569 | 3,000 |
| Estimated in-migration | 609 | 648 | 764 | 996 |
| Difference between actual and estimated in-migration | (192) | 63 | 85 | 2,004 |
| Difference between actual and estimated in-migration as a percentage of total cases | (.2%) | .1% | .8% | 1.5% |

** Source: Calculated from Table 1 and Figures 1 and 2.
( ) denotes negative

# Special Comments

## Zoning and Land Use

### Where Is Indiana Zoning Headed?

WILLIAM F. LEMOND*

#### I. HISTORICAL BACKGROUND

#### A. *Enabling Legislation*

The failure of the common law nuisance action, a growing urbanization, a post-World War I housing boom, and the beginning of the golden era of the mass-produced automobile all materially contributed to the abandonment of traditional legal remedies for a new and untried field of property law: zoning. The United States Supreme Court, in 1926 in *Village of Euclid v. Ambler Realty Co.*,[1] upheld a comprehensive zoning scheme enacted by the Village Council of Euclid, Ohio. Even prior to the *Euclid* Court's legitimization of zoning, the Indiana General Assembly in 1921 granted the common council of each city the power to regulate land use by the creation of zoning ordinances.[2]

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[1]272 U.S. 365 (1926). On November 13, 1922, the Village Council of Euclid, Ohio, adopted a comprehensive zoning plan which established building requirements and regulated and restricted the location of trades, industries, single and multi-family residences, and apartment houses. The appellee assailed the ordinance and asked that its enforcement be enjoined on the ground that it deprived him of liberty and property without due process by restricting the lawful uses of his land "so as to confiscate and destroy a great part of its value." *Id.* at 384. The Supreme Court upheld the ordinance as a reasonable exercise of the police power in the interest of public health, safety, morals, and the general welfare.

[2]Ch. 225, §§ 1-7, [1921] Ind. Acts 660, *as amended*, ch. 125, §§ 1-3, [1925] Ind. Acts 304 (repealed 1947). This enabling statute granted the common council of each city the power:

> To classify, regulate and limit the height, area, bulk and use of buildings hereafter to be erected; . . . to regulate and determine the use and intensity of use of land and lot areas; to classify, regulate and restrict the location of trades, callings, industries, commercial enterprises and the location of buildings designed for specified uses; to divide the city into districts of such kinds, character, number, shape and area as it may deem best suited to carry out any or all of the purposes of this section.

Later, in 1947, unincorporated areas and small cities and towns were granted similar zoning and districting powers.[3] Significantly, this legislation possibly constituted the most serious interference with property rights since the creation of the fee simple absolute, because to regulate land use is to control the basic structure of community growth.

Because this regulatory authority was predicated upon the exercise of the state's police power in the interest of public health, safety, and general welfare, such power could be exercised only by an elective body as a legislative function. Ironically, one of the most serious criticisms of the zoning process today is that its status as a legislative function has caused it to become tainted by politics and the parochial interest of local pressure groups.

Interestingly, Indiana law does not contain any serious constitutional arguments against the early zoning ordinances, although in *General Outdoor Advertising Co. v. City of Indianapolis Department of Public Parks*,[4] the Indiana Supreme Court made collateral reference to the constitutionality of zoning ordinances when it cited *Euclid*.[5] The litigants in *General Outdoor Advertis-*

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Ch. 225, § 1, [1921] Ind. Acts 660 (repealed 1947). The statute directed that the common council, in making the regulations and districts, "pay reasonable regard to existing conditions, the character of the buildings erected in each district, the most desirable use for which the land of each district may be adapted and the conservation of property values throughout the city." *Id.* at 661. The common council was granted the authority to amend or supplement the regulations after public notice and hearing. *Id.* § 3, at 662. Every proposed change was required to first be submitted to the city plan commission for consideration before any final action could be taken by the city council. *Id.* The common council was empowered to create a five-member board of zoning appeals, whose function was to hear and determine appeals from any "order, requirement, decision or determination" made by administrators charged with enforcing the zoning ordinance and to authorize execptions to and variations from the ordinance. *Id.* § 4, at 664. Decisions of the board of zoning appeals were subject to review by certiorari upon an allegation of illegality. *Id.* §§ 4-5.

The City of Indianapolis was the first city in Indiana to promote land use reform with a general ordinance closely patterned after the enabling act. Indianapolis, Ind., Gen. Ordinance 114, Dec. 4, 1922.

[3]Ch. 174, §§ 1-93, [1947] Ind. Acts 571, *repealing* ch. 225, [1921] Ind. Acts 660, *as amended*, ch. 125, [1925] Ind. Acts 304. Comprehensive enabling legislation is now codified at IND. CODE §§ 18-7-1.1-1 *et seq.* (1974) (regional planning); *id.* §§ 18-7-2-1 *et seq.* (metropolitan planning in first-class cities and counties); *id.* §§ 18-7-3-1 *et seq.* (metropolitan planning in larger counties); *id.* §§ 18-7-4-1 *et seq.* (area planning); *id.* §§ 18-7-5-1 *et seq.* (advisory plan commissions); *id.* §§ 18-7-5.5-1 *et seq.* (multi-county planning).

[4]202 Ind. 85, 172 N.E. 309 (1930).

[5]The court cited *Euclid* in support of its statement that restrictions on individual rights become more common as social relations become more complex:

*ing*, however, did not question the validity of a zoning ordinance, but challenged a specific park board ordinance which prohibited and ordered the removal of existing outdoor advertising signs within 500 feet of a park or parkway. Unlike enabling zoning legislation, the legislation authorizing this ordinance made no provision for zone districting and instead gave park boards the power of eminent domain in compensating for the mandatory removal of a lawfully established sign.

*City of Indianapolis v. Ostrom Railroad & Construction Co.*[6] is exemplary of the confusion found in early Indiana zoning decisions. This case arose from an attempt by a city plan commission to change a zone district by resolution. The Indiana Court of Appeals ruled that such a change could be made only by ordinance enacted by a common council. The court then proceeded to define the powers of a board of zoning appeals and suggested, without explanation, that the land use change of six lots from residential to commercial use was beyond the power of the board of zoning appeals and was illegal. Thus, the court, by judicial legislation, established standards concerning the powers of the boards beyond the express language of the enabling statute. The court stated that the boards were probably created because the legislature realized that there would be "many *small* matters in which is a *very slight deviation* from the ordinance" could be made without reduction in the value of neighboring property and without harm to the general public welfare.[7] The statute, by comparison, granted the boards power to modify the provisions of an ordinance whenever "there are practical difficulties or unnecessary hardship in the way of carrying out the strict letter of such ordinance."[8] The modifications should be made "so that the spirit of the ordinance shall be observed, public welfare secured or substantial justice done."[9]

### B. *Strict Construction of the Enabling Acts*

Judicial review of zoning recommendations, decisions, and ordinances made by planning commissions, common councils, and boards of zoning appeal has been strictly limited. Land use change

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> Restrictions which years ago would have been deemed intolerable and in violation of the property owners' constitutional rights are now desirable and necessary, and zoning ordinances fair in their requirements are usually sustained.

*Id.* at 97, 172 N.E. at 313.

[6]95 Ind. App. 376, 176 N.E. 246 (1931).

[7]*Id.* at 382, 176 N.E. at 248 (emphasis added).

[8]Ch. 125, § 2, [1925] Ind. Acts 304, *amending* ch. 225, § 4, [1921] Ind. Acts 660 (repealed 1947).

[9]*Id.*

by rezoning was exclusively delegated to legislative bodies.[10] Thus, the landowner aggrieved by an oppressive and unreasonable zoning land use restriction had no recourse to the courts to question the wisdom or discretionary authority of the legislative action. Although the enabling statutes made it mandatory that a rezoning petition be filed and presented in public hearing to a plan commission before being certified to a common council, the actions taken by these plan commissions were likewise not reviewable by the courts:

> [S]uch actions are recommendations of an advisory nature only, which are inoperative and ineffectual for any purpose unless acted upon by the proper municipal authority [common council], or allowed to become operative by the reason of the failure of a Board of County Commissioners [or a common council] to act within the 60-day period.[11]

Thus, an enigma resulted. A property owner with an unreasonable restriction upon his land could not appeal the recommendation of a plan commission because the commission acted only in an advisory capacity and did not render an appealable final decision or order. He could not attack an ordinance enacted by a common council because the council acted in a legislative capacity. Although he could appeal to a board of zoning appeals for a variance of use,[12] his chances of success there were far from certain. In typical communities, professional planners hired by plan commissions as their executive directors would design a mas-

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[10]The legislative body with authority to amend or modify a zoning ordinance was either a city council, a town board of trustees, or a board of county commissioners, depending upon whether the zoned area was an incorporated city or town, or a rural unincorporated area. Ch. 174, §§ 1, 3, [1947] Ind. Acts 571.

[11]McGraw v. Marion County Plan Comm'n, 131 Ind. App. 686, 694, 174 N.E.2d 757, 761 (1961). A plan commission is empowered by statute to adopt a master plan after public hearing and to certify this plan to the common council or board of county commissioners with a recommendation that the plan be enacted. If the council or commissioners fail to take action within sixty days after the certification, the ordinance becomes effective as though enacted. IND. CODE §§ 18-7-5-41, -42 (Burns 1974).

[12]IND. CODE § 18-7-4-78 (Burns 1974). A variance of use differs from rezoning by amendment to the master plan in that rezoning contemplates the enactment of an ordinance permanently changing the general zoning classification, which classification might allow a variety of related residential, commercial, or industrial uses. A variance of use, on the other hand, varies the terms of the master plan ordinance as it applies to a particular tract of land and authorizes a particular use of the property not authorized by the existing zoning classification. Although an owner of land with a variance can sell his land and business as a going concern to others for the same use and purpose, the use of the land may not be changed without obtaining another variance or a rezoning authorizing the new use.

ter plan for community growth.[13] When a landowner appealed to a board of zoning appeals for a variance from the master plan, he was immediately at odds with the professional planning staff. Literally, every variance that is granted is a commentary on the inefficacy of the master plan.[14]

Further, although decisions of the boards of zoning appeals were reviewable by way of certiorari, early court opinions built a wall of insularity around these decisions and refrained from reversing when a board denied a variance. For example, in *Board of Zoning Appeals v. Waintrup*,[15] a property owner with a residential use restriction upon his property sought a variance to conduct a furniture store on the premises.[16] The board denied the variance, the trial court reversed the board, and the Indiana Court of Appeals reinstated the denial. The court of appeals stated that a reviewing court on appeal by way of certiorari has no discretionary authority and can consider only specific allegations of illegality. The court intimated that there could never be illegality in the decision of a board in its discretion to deny a variance.[17]

[13]A master plan zoning ordinance is one adopted as a comprehensive land development scheme for community growth. The master plan may involve not only land use districting, but also thoroughfare plans, flood control plans, park and school plans, subdivision control, etc. In recommending a master plan, a plan commission is directed to consider the existing conditions and uses of the land involved, the most desirable use, and the conservation of property values. *Id.* § 18-7-4-46.

[14]In creating the boards of zoning appeals, the legislature realized that master plan zoning ordinances, although objectively enacted to enhance the general public welfare, might contain inequitable and arbitrary restrictions on particular parcels of land. One function of the boards is to grant relief in the form of variances and exceptions of use upon particular parcels when the master plan creates a true zoning hardship. *Id.* § 18-7-4-78. The boards are truly quasi-judicial bodies, whose findings of fact and conclusions of law are by statute subject to judicial review. *Id.* § 18-7-4-89.

[15]99 Ind. App. 576, 193 N.E. 701 (1935).

[16]The issue of the constitutionality of the ordinance as it applied to the appellee was raised, and the court stated that constitutionality of a zoning ordinance could not be put in issue in a variance proceeding. *Id.* at 588, 193 N.E. at 704. This statement was subsequently overruled by the Indiana Supreme Court in City of South Bend v. Marckle, 215 Ind. 74, 18 N.E.2d 764 (1939).

[17]An allegation that strict enforcement of the zoning ordinance will result in practical difficulty and unnecessary hardship to the petitioner for a variance, and that strict enforcement is not in keeping with the spirit of the zoning ordinance, is not an allegation that the board's action in denying a variance was illegal. 99 Ind. App. at 586, 193 N.E. at 704. The court clearly stated that the decision of the board to grant or deny a variance of use is discretionary and by statute there can be no illegality in the use of this discretion:

> Whether the board should act and vary the ordinance is a matter for the board to determine in its discretion, and such discretionary action, unless illegal, is not subject to review. If it had varied

In *O'Connor v. Overall Laundry, Inc.*,[18] an overall laundry predating the 1922 city zoning ordinance and located in a residential district sought to connect two existing commercial buildings for greater efficiency of operation. The board of zoning appeals denied a variance, the trial court reversed, and the Indiana Court of Appeals reinstated the denial. The court of appeals especially emphasized that "the power of authorizing variations from the general provisions of the statute is designed to be sparingly exercised."[19]

Possibly the most exemplary case showing the courts' persistent refusal to overturn variance denials is *Board of Zoning Appeals v. American Fletcher National Bank & Trust Co.*[20] In this case, a property owner sought a variance to build a service station on apartment-zoned land because the tract was too small for apartment development and financing could not be obtained. A church and an apartment developer protested, however, on the basis of noise and unsightliness interfering with the use of their respective properties. The variance was denied. Again, the trial court reversed, but the Indiana Court of Appeals reinstated the variance denial. The court of appeals emphasized the administrative character of the zoning board and its special expertise in the zoning problems of its jurisdiction: "Therefore, the Board

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> the ordinance and had acted illegally in doing so, then persons who were thereby aggrieved would have the right to have such action reviewed as provided by statute. . . .
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> . . . . The fact is that the board failed to vary the ordinance so there could be no illegality in the decision as provided by the statute. Whether its decision was contrary to law is not a ground for review under the statute.

*Id.* at 586-87, 193 N.E. at 704-05.

[18]98 Ind. App. 29, 183 N.E. 134 (1932).

[19]*Id.* at 37, 183 N.E. at 137, *quoting from* Norcross v. Board of Appeal of Bldg. Dep't, 150 N.E. 887, 890 (Mass. 1926). The *O'Connor* court noted that although the laundry was in the district when the zoning ordinance was adopted, the intent of the ordinance was that nonconforming uses should be discouraged from remaining in the districts. 98 Ind. App. at 39, 183 N.E. at 138. The court emphasized that the public health, safety, and general welfare of the community "must be the pole star for the guidance of the board." *Id.* at 39, 183 N.E. at 138. Important considerations in this regard are stability of the community and protection of neighboring property:

> The financial situation or pecuniary hardship of a single owner affords no adequate ground for putting forth this extraordinary [variance] power effecting other property owners as well as the public. . . . This is quite insufficient to constitute "unnecessary hardship" or to involve "practical difficulty."

*Id.* at 38, 183 N.E. at 138, *quoting from* Prusik v. Board of Appeals of Bldg. Dep't, 160 N.E. 312, 314 (Mass. 1928).

[20]139 Ind. App. 9, 205 N.E.2d 322 (1965).

has wide discretion whether or not to grant a variance to a zoning ordinance, . . . [and] the trial court may not substitute its discretion for that of the Board."[21]

*Metropolitan Board of Zoning Appeals v. Standard Life Insurance Co.*[22] summarily represents the difficulty in obtaining a variance. Standard Life owned residentially-zoned property at a business intersection between its office building to the west and a Shell service station and theatre to the east. The highway authority effectively put the Shell station out of business through a highway improvement program, and Shell desired to relocate on the Standard Life property across the street. Only the technical staff of the plan commission and a representative of the Indianapolis Redevelopment Commission who believed that the requested variance would interfere with rehabilitation, redevelopment, and code enforcement were present at the hearing. No neighborhood remonstrators attended.

The court of appeals, in affirming the board's denial of a variance, emphasized the five statutory prerequisites to obtaining a variance[23] and placed the burden of proof by substantial evi-

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[21]*Id.* at 12, 205 N.E.2d at 324. At least, by 1965, the court indicated that it might overturn a variance denial if, from the evidence presented before the board and before the court, it could "be concluded as a matter of law that the grant of a variance would not be injurious to the public health, safety and morals and general welfare of the community, or that the use or value of the area adjacent to the property included in the proposed variance would not be adversely affected." *Id.* at 14, 205 N.E.2d at 325.

[22]145 Ind. App. 363, 251 N.E.2d 60 (1969).

[23]In the 1921 enabling legislation, it was provided that a variance could be granted when there are "practical difficulties or unnecessary hardship in the way of carrying out the strict letter of such ordinance," so long as "the spirit of the ordinance shall be observed, public welfare secured or substantial justice done." Ch. 225, § 4, [1921] Ind. Acts 660, *as amended*, ch. 125, § 2, [1925] Ind. Acts 304 (repealed 1947). The 1947 legislation similarly provided that a variance could be granted, if not contrary to the public interest, "where, owing to special conditions, a literal enforcement of the ordinance will result in unnecessary hardship, and so that the spirit of the ordinance shall be observed and substantial justice done." Ch. 174, § 77, [1947] Ind. Acts 569.

In 1955, these general statements of authority were expanded to five statutory prerequisites which must be proved by petitioner and detailed as findings by the board:

> 1. The grant will not be injurious to the public health, safety, morals, and general welfare of the community.
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> 2. The use or value of the area adjacent to the property included in the variance will not be adversely affected.
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> 3. The need for the variance arises from some condition peculiar to the property involved and does not exist in similar property in the same zone.
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> 4. The strict application of the terms of the ordinance will constitute an unusual and unnecessary hardship if applied to the property for which a variance is sought.

dence upon the petitioner. The court stated that it is inappropriate to require justification by the board of a negative decision.[24]

### C. Liberalizing Trends of Statutory Construction

While the courts were insulating the boards from judicial review, however, signs of greater latitude in the jurisdictional authority of boards of zoning appeal were beginning to appear. For years, the courts stringently interpreted the boards' authority. Thus, in 1952 in *Antrim v. Hohlt*,[25] when petitioners sought a variance to build an eighty-three unit apartment building in a residential district, the variance was denied, and the denial was upheld by the court of appeals, which stated:

> Any variance which so changes the character of an area so that it is not in harmony with the general purpose and intent of the zoning ordinance must be effected by an amendment of the zoning ordinance of which the master plan is a part.[26]

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> 5. The grant of the variance does not interfere with the metropolitan comprehensive plan adopted pursuant . . . [to] this act: Provided that no zoning ordinance or ordinances classifying or restricting the use of or otherwise applicable to the property involved shall be considered to be part of such metropolitan comprehensive plan.

Ch. 283, § 69, [1955] Ind. Acts 786, *as amended*, IND. CODE § 18-7-2-71 (Burns 1974). The first requirement requires proof, for example, that the use will serve the community and that utilities and other municipal facilities are available to serve the intended use. The second prerequisite might involve proving that similar uses are established in the district and that the proposed use is harmonious to existing uses. The third might be established by showing, for example, that the property in question is the only property in the zone district contiguous to a railroad track. The fourth requires a showing, for example, that the property is not usable in its unimproved state and is unmarketable for use as zoned, so that the owner is paying taxes and maintenance on land of which he has been deprived the beneficial use and enjoyment. Ingenuity and imagination may be required to convince the board that the proposed use will not decrease the use of or value of adjacent property; however, this element is as flexible as the imagination, since landscaped buffer strips, attractive fencing, and intelligent use of natural buffers may effectively render the neighboring property owners unaware of the proposed use.

[24]The court noted the substantially different standards of review of board decisions granting or denying a variance. To reverse a denial, the reviewing court must find that the five statutory prerequisites have been established as a matter of law, resolving all evidentiary doubts in favor of the board's decision. In reversing a grant of variance, it is immaterial that there is substantial evidence tending to show the converse of the board's determination. The question then is whether there is "substantial evidence of probative value authorizing the grant of a variance." *See also* R.J. Realty, Inc. v. Keith, 145 Ind. App. 314, 250 N.E.2d 757 (1969).

[25]122 Ind. App. 681, 108 N.E.2d 197 (1952).

[26]*Id.* at 686, 108 N.E.2d at 199.

The liberating trend allowing greater jurisdictional authority first emerged soon after the *Antrim* decision. As early as 1953, in *City of East Chicago v. Sinclair Refining Co.*,[27] a plan commission caused thirty-four acres of land to be rezoned from an industrial classification to a residential classification. A large industrial concern, owning this land for future development in conjunction with adjacent industrially-improved land, was denied permission to expand its laboratory and bulk storage facilities on the land. The company filed a declaratory judgment action and emphasized that it had owned the land for many years before zoning and had embarked on a substantial industrial development program in reliance upon opportunities for future expansion on this land. The trial court granted judgment for the company on the theory that the zoning officials had acted illegally in taking, by imposing an unreasonable restriction on, Sinclair's land. The Indiana Supreme Court reversed the trial court for failure of the company to exhaust its administrative remedy of applying for a variance.[28] In dictum, however, the court stated that thirty-four acres of land was not too large an area for a board of zoning appeals to consider for a variance.[29] Thus, the court expressly modified the judicial standards enunciated earlier in *City of Indianapolis v. Ostrom Realty & Construction Co.*[30]

Concomitant with the enlargement of jurisdictional authority was a gradual deterioration in the insulation of the boards of zoning appeals from judicial review. *Board of Zoning Appeals v.*

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[27]232 Ind. 295, 111 N.E.2d 459 (1953).

[28]The court relied upon its earlier decision in City of South Bend v. Marckle, 215 Ind. 74, 18 N.E.2d 764 (1939), to require exhaustion of the administrative remedy of applying for a variance.

In *Marckle,* the court summarized the rules of review of zoning recommendations and decisions: (1) A court will not review an exercise of the discretionary powers of a board unless there is a clear abuse of discretion, (2) an appeal by way of certiorari is proper when the board has acted illegally, even though the illegality is a violation of petitioner's constitutional rights, so long as it is not claimed that the entire ordinance is invalid, and (3) when it is asserted that the entire ordinance is invalid, the remedy is not by certiorari but by direct action. *Id.* at 82-83, 18 N.E.2d at 767. Since the petitioners in *Sinclair* claimed only that the ordinance was unreasonable as it applied to them, the proper course for them to follow was to apply to the board for a variance to relieve the hardship and, if relief was not granted, to ask a review in the circuit court by way of certiorari.

[29]232 Ind. at 312, 111 N.E.2d at 464.

[30]95 Ind. App. 376, 176 N.E. 246 (1932). The *Ostrom* court had held that an attempt by the board to modify by variance an entire city block without an ordinance by the common council was not contemplated by the statute. The *Sinclair* court expressly stated that the authority of the board to modify ordinances when the conditions impose unnecessary hardship is nowhere limited to property of a certain area or size. Unnecessary hardship must be determined by considering all relevant factors.

*Decatur, Indiana Co. of Jehovah's Witnesses*[31] is an early indication of this development. The court found justification for reversing the decision of a board of appeals which had denied a variance of building setback and parking requirements when a religious group sought authorization to build a church in a residentially-zoned area. The court balanced the interests of freedom of worship and of promoting the public welfare by land use restrictions and found that the refusal to grant a variance, which refusal resulted in the exclusion of a church from a residential district, was a denial of the right of freedom of worship. Thus, the zoning board decision was reversed because the interest in land use control did not outweigh the opposing constitutional interest.

*Town of Homecroft v. Macbeth*[32] was the first major decision to penetrate the veil of administrative insularity. Macbeth owned and operated a rural grocery which successfully traded in a market of farm neighbors and passers-by until, eventually, a community of single-family housing was built around his property. The community incorporated itself into a town, adopted a zoning ordinance, and created a master plan which relegated his property to single-family residential use. As a result of these developments and changes, and since Macbeth could not be put out of business without just compensation, his property became what is known as a lawfully established nonconforming use. According to this designation, one can continue his present business operation ad infinitum, but if he proposes a new use, it must conform to the master plan.

Unfortunately, because of competition from suburban chain supermarkets, the grocer was forced out of business to avoid bankruptcy. After two years of offering his property for sale, the only bona fide offer he received was from the Pure Oil Company who proposed to tear down the market and erect a Pure Oil Gasoline Service Station. Application was made to the Town of Homecroft Board of Zoning Appeals for a variance to permit the gas station use. The people of Homecroft, encouraged by the vice-president of a neighboring competitive oil company, arose in indignant protest against the proposed variance from their master plan. Unsurprisingly, the variance was denied.

The Indiana Supreme Court held that the zoning ordinance established by the town of Homecroft was unconstitutional as applied to Macbeth. The court gave particular emphasis to the fact that the lot in question was not suitable for use as a residential area and stated that "an ordinance which *permanently* so re-

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[31]233 Ind. 83, 117 N.E.2d 115 (1954).

[32]238 Ind. 57, 148 N.E.2d 563 (1958).

stricts the use of property that it cannot be used for any reasonable purpose goes, it is plain, beyond regulation, and must be recognized as a taking of the property."[33] Further, the supreme court raised doubts that the power to restrict property use should be vested in administrative bodies which are subject to personal and political considerations.[34]

In *Board of Zoning Appeals v. LaDow*,[35] a board of appeals denied a building permit for the construction of a service station in a commercial zone because the city had amended its zoning ordinance to prohibit per se service stations in any commercially-zoned area. The Indiana Supreme Court stated that this prohibition was violative of due process according to both the Indiana and the United States Constitutions. This result is not surprising, but the case did set a precedent for the use of an additional remedy by a landowner laboring under a confiscatory classification. In *LaDow*, the property owner did not apply for a variance. Instead, he appealed the denial of a building permit to the board on entirely constitutional grounds. The court stated that the denial of an application for a building permit is contemplated and authorized by the act creating boards of zoning appeal as an appealable "order," "decision," or "determination" by an administrative official.[36] Thus, the question was appropriately presented.

Nobody took the *LaDow* case too seriously because its stark facts dictated that relief should be granted, whatever the empirical recourse to stare decisis indicated. However, this somewhat obscure case became very important in New Albany, Indiana, in

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[33] *Id.* at 68, 148 N.E.2d at 569, *quoting from* Arverne Bay Constr. Co. v. Thatcher, 278 N.Y. 222, 232, 15 N.E.2d 587, 592 (1938). The *Homecroft* court stated that an "attempt to zone for residential purposes only, property fronting on a busy highway, in order to provide a beautiful and dignified village frontage can be unreasonable under restriction of the property to uses to which it is not adapted." 238 Ind. at 68, 148 N.E.2d at 569.

[34] The court stated:

> [I]t is . . . apparent that the power to restrict the uses of private property under the police power should be exercised with caution, and that when the power in the first instance is vested in municipal officers, who are not trained in the history and traditions of the law, and who may be particularly subject to personal and political considerations, there exist grave dangers that owners may be deprived of their constitutional rights in the use of their property.

238 Ind. at 64, 148 N.E.2d at 567.

[35] 238 Ind. 673, 153 N.E.2d 599 (1958).

[36] *Id.* at 679, 153 N.E.2d at 602. The applicable statute provides for appeals to the board and review of any "requirement, decision or the determination made by an administrative official or board charged with the enforcement of any ordinance" adopted pursuant to the enabling legislation. IND. CODE § 18-7-4-79 (Burns 1974).

a case which arose a few years later. In *Board of Zoning Appeals v. Koehler*,[37] a new master plan provided for commercial centers in the periphery of the county but in such isolated circumstances and with such poor utilities and roads that it was unlikely they would ever develop.[38] The Koehler property was situated in a large and growing commercial section of the city which was zoned for residential use. Instead of seeking a rezoning, which involves a discretionary legislative act with no judicial recourse, or seeking a variance, in which case the burden of proving the statutory prerequisites is an onerous one for petitioner, Koehler appealed the denial of a building permit, asserting that the ordinance was unconstitutional as applied to her property. Relying on *Homecroft* and *LaDow,* the Indiana Supreme Court ruled in favor of the landowner and reiterated that the constitutionality of a zoning ordinance as applied to a specific tract of land can be brought to court from the zoning board after the denial of a variance or after the denial of a building permit.

*Metropolitan Board of Zoning Appeals v. Gateway Corp.*[39] involved a factual situation similar to that in *Homecroft* except that the owner in *Gateway* wanted to build townhouses on single-family zoned land. The property contained residential improvements of such age and condition that they had been ordered razed by the public health authorities, and there was no market or mortgage financing available to build new single-family dwellings in the area. The court again relied on the *Homecroft* case and, more particularly, declared that the five statutory standards governing the approval of a variance have no application when the issue of the constitutionality of the zoning ordinance is involved.

Most recently, in *Metropolitan Board of Zoning Appeals v. Sheehan Construction Co.*,[40] the Indiana Court of Appeals upheld, on constitutional grounds, the trial court's reversal of the decision of a zoning board to deny a variance. In discussing the scope of review, the court of appeals distinguished review founded on statutory guidelines, in which case the burden is on the petitioner to establish the five statutory prerequisites and the appellate court must consider all the evidence in the light most favorable to the board's decision, and a review founded on constitutional guidelines, in which case the trial court may consider the evidence de novo and the appellate court must consider all the evidence in the light most favorable to the trial court's decision. Sheehan's argument was that, since the property was not suited for residential

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[37]244 Ind. 504, 194 N.E.2d 49 (1963).

[38]Obviously the plan commission was dominated by a strong downtown merchants' association when the master plan was adopted.

[39]256 Ind. 326, 268 N.E.2d 736 (1971).

[40]313 N.E.2d 78 (Ind. Ct. App. 1974).

single-family development, the zoning ordinance was unconstitutional and confiscatory as applied to this property. The court of appeals stated:

> The commercial proliferation of this area by the granting of variances has so changed its character that the zoning restrictions placed upon it are no longer realistic or meaningful. The enforcement of such restrictions can only result in the deprivation of property to those chosing [*sic*] a different use not incongruous to the surroundings.[41]

The court cautiously pointed out, however, that not every zoning burden placed upon private property constitutes a confiscation or taking. A distinction must be made between an assertion that a parcel of property is not zoned for its best and most profitable use and a finding that the zoning restriction results in a deprivation of property rights. Significantly, only the latter is confiscatory.

If there appear to be inconsistencies in the case law of zoning, it is perhaps because the appellate tribunals were unwillingly thrust into an uncharted course of law without historical precedent. Thus, when a citizen owns real estate which has virtually no value as restricted by an unrealistic zoning classification, and he has an economic opportunity to realize a substanial value from the land by changing its use in a manner not inconsistent with land use changes in the neighborhood, it is difficult for a constitutionally-oriented judiciary to disregard his plea for "equal treatment under the law."

### D. *Future Problems of Interpretation*

In reviewing the increasing number of zoning enabling acts, the increasing number of amendments to these acts, and the rapidly growing body of case law concerning zoning, it is apparent that planning and zoning have not been the panacea of orderly community growth its creators envisioned. The divergence in Indiana between enabling acts for cities, cities of the first class, towns, counties, and other areas evidence the perennial efforts of the General Assembly to find better ways of land use regulation. Unfortunately, there is little uniformity among these acts. For example, the acts have different statutory requirements which must be met before a variance may be granted.[42] Since statutory

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[41]*Id.* at 83.

[42]*Compare, e.g.,* IND. CODE § 18-7-2-71 (Burns 1974) (establishing five statutory prerequisites for the granting of a variance in cities and counties of the first class, which encompasses only Indianapolis and Marion County) *with id.* § 18-7-4-78 (establishing four statutory prerequisites for the grant-

variations do not promote uniformity in law, an onerous burden will eventually be placed upon appellate tribunals to resolve the conflicts.

## II. Current Trends in Land Use Regulation

The decline of the railroad and the rise of the trucking industry have dramatically affected the growth of communities and their social and economic structure. Moreover, the post-World War II housing boom, the increasing dependence upon the automobile, and the existence of less expensive lands in the rural periphery surrounding the cities resulted in a more ambulatory society and a flight to the suburbs. Other, dramatic changes have occurred because of this flight to the suburbs. The development of one of the most elaborate interstate highway systems in the world has made thousands of acres of relatively cheap land within easy commuting distance of most employment centers. Concomitantly, the employment centers have relocated from the traditional inner-city railroad sidings to the periphery of the community and to even smaller satellite communities. Planning and zoning were caught in the middle of these changes.

Furthermore, the inner cities have undergone a socio-economic upheaval. Because of the movement to the suburbs, inner cities have a lower tax base to support municipal facilities depended upon by the suburban dwellers. Increasingly, only the lower income elements, notably minority groups, remain locked into the inner-city environment. Closed inner-city schools, busing, increased crime rates, and vacant and vandalized older structures are symptoms of the inner-city problems. Subsidized housing, federal grants-in-aid for demolition, rehabilitation, and redevelopment, and neighborhood participation in local government are typical of recent attempts to alleviate the cities' dilemma.

Conversely, suburban life has not turned out to be the idyllic life of grassy meadows, green forests, and clear streams that may have been expected. Development patterns of similar houses on similar lots with similar families emerged across the landscape. This questionable result was achieved through zoning restrictions which mandated sameness. For example, typical master plans disallowed $40,000 homes in $25,000 neighborhoods and prohibited multi-family housing, subsidized housing, shopping facilities, and commercial centers in suburban areas. Escalating property taxes in support of a burgeoning public school system

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ing of a variance and prohibiting the grant of a variance from a use district or classification). The fifth prerequisite for first-class cities and counties requires a finding that the grant of a variance "will not interefere substantially" with a metropolitan comprehensive plan. *Id.* § 18-7-2-71.

and rapidly expanding (and expensive) utility services represent a further jaundice to the suburban scene. Impact zoning, cluster housing, green-area planning, and density zoning represent recently devised methods of controlling development so as to minimize ill effects on the environment and on the economy.

The courts have been thrust directly into these experiments in social engineering, and, for the first time since *Village of Euclid v. Ambler Realty Co.,*[43] the federal courts are playing an increasing role in policy determination. Federal intervention to date has been largely in the field of exclusionary zoning.[44]

In *Dailey v. City of Lawton,*[45] a housing sponsor for the Diocese of Oklahoma City applied to the city for a multi-family, federally-subsidized, low-cost housing project in a white multi-family neighborhood. This request was rejected by the City. The Court of Appeals for the Tenth Circuit, however, upheld the district court which overruled the City and ordered the land zoned to allow for the housing project. The court emphasized that plaintiffs had established racial prejudice as a potential motive for the City's decision and the City had failed to negate this showing by anything more than "bald, conclusory assertions that the action was taken for other than discriminatory reasons."[46] Thus, the court placed the burden of proof in a zoning challenge of this nature upon the City.

*Southern Alameda Spanish Speaking Organization v. City of Union City*[47] arose out of a similar factual situation. In *SASSO,* a Mexican-American sought to build a multi-family project on twenty-four acres of land outside the ghetto section of the city. Passage of a rezoning ordinance was successfully obtained, but the white citizenry called for a referendum and the rezoning ordinance was nullified.[48] SASSO sought injunctive relief to imple-

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[43]272 U.S. 365 (1926).

[44]Exclusionary zoning is a term to describe zoning practices which effectively exclude minority group members from communities in which they desire to live. Exclusionary zoning is typically accomplished by frustration of the ability of members of the excluded groups to move into the community. See Note, *Exclusionary Zoning: Will the Law Provide a Remedy?,* at pp. 995-1027 *infra.*

[45]425 F.2d 1037 (10th Cir. 1970).

[46]*Id.* at 1040.

[47]424 F.2d 291 (9th Cir.), *aff'g* 314 F. Supp. 967 (N.D. Cal. 1970).

[48]Article XXXIV of the California Constitution mandates a referendum to approve a proposal involving low-cost public housing. The validity of this referendum procedure was upheld in James v. Valtierra, 402 U.S. 137 (1971), wherein the Court stated that the procedure "ensures that all the people of a community will have a voice in a decision which may lead to large expenditures of local governmental funds for increased public services and to lower tax revenues." *Id.* at 143. The Court further commented:

ment the zoning change and attacked the referendum and its results as violative of its constitutional rights. The issue before the Ninth Circuit Court of Appeals was whether or not to raise a three-judge federal court to consider the constitutional questions. Although the Ninth Circuit determined that a three-judge court should not be convoked, the court succinctly stated the issues to be determined in considering plaintiff's allegations:

> Surely, if the environmental benefits of land use planning are to be enjoyed by a city and the quality of life of its residents is accordingly to be improved, the poor cannot be excluded from enjoyment of the benefits. Given the recognized importance of equal opportunities in housing, it may well be, as a matter of law, that it is the responsibility of a city and its planning officials to see that the city's plan as initiated or as it develops accommodates the needs of its low-income families who usually—if not always—are members of minority groups.[49]

While the exclusionary zoning battle is raging in both federal and state court systems, many unique devices are being designed to control, limit, and even eliminate growth. In *Golden v. Planning Board*,[50] a "slow growth" zoning ordinance was recently upheld. This particular ordinance established a point system which required potential builders to qualify by accumulating fifteen of a possible twenty-three points. These points were based on the availability of five municipal services: sewers, drainage, roads, firehouses, and parks and schools. The point system was keyed to an eighteen-year municipal capital improvements program, and, if the developer did not want to subsidize the missing municipal service to obtain the needed fifteen points, he was forced to wait until the capital improvements program caught up with his property.

More recently, in *Construction Industry Association v. City of Petaluma*,[51] although a "slow growth" ordinance was struck down by the district court, the Ninth Circuit reversed and upheld the ordinance. The City of Petaluma had experienced a population growth

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"Provisions for referendums demonstrate devotion to democracy, not to bias, discrimination, or prejudice." *Id.* at 141.

[49]424 F.2d at 295-96. Courts have struck down zoning restrictions and building requirements which have an exclusionary effect. *See, e.g.*, Kennedy Park Homes Ass'n v. City of Lackawanna, 318 F. Supp. 669 (W.D.N.Y. 1970) (land restricted to use as a park and no further building allowed); Appeal of Girsh, 263 A.2d 395 (Pa. 1970) (zoning plan failed to provide for apartments and was unconstitutional); Appeal of Kit-Mar Builders, Inc., 268 A.2d 765 (Pa. 1970) (minimum lot size requirements struck down).

[50]30 N.Y.2d 359, 285 N.E.2d 291, 334 N.Y.S.2d 138 (1972).

[51]44 U.S.L.W. 2093 (9th Cir., Aug. 13, 1975), *rev'g* 375 F. Supp. 574 (N.D. Cal. 1974).

from 19,050 in 1965, to 29,500 by the end of 1971, and attempted to restrict growth to a maximum of 500 new living units per year. The district court stated that a municipality "capable of supporting a natural population expansion [may not] limit growth simply because it does not prefer to grow at the rate which would be dictated by prevailing market demand."[52] The Ninth Circuit, however, found the restriction reasonably related to a legitimate state interest. The Ninth Circuit noted that the ordinance does not freeze the present population levels and does not have the "effect of walling out any particular income class or any racial minority group,"[53] unlike other zoning ordinances struck down by courts in recent years.[54]

Fiscal zoning is another vehicle currently being attempted to control growth. The Florida Court of Appeals held that developers of property can provide for the furnishing of essential services and, by covenants, bind the owners of lots to pay for them.[55] However, the Supreme Court of Utah struck down a provision in the State Health Code which would have added between $125 and $1000 to the cost of a house for a back flow prevention device to be installed in sprinkling systems.[56]

In addition to the ever-increasing judicial decisions in the area of land use regulation, a series of both federal and state legislation has arisen in an attempt to improve regional considerations in community growth for the benefit of both the home environment and the ecological environment. Perhaps the most notable of the proposed legislation is a bill[57] which would provide about $800 million in federal aid to the states for establishing

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[52]375 F. Supp. at 583. The basis of the court's decision was the constitutional right to travel.

[53]44 U.S.L.W. at 2093.

[54]In Ybarra v. City of Los Altos Hills, 503 F.2d 250 (9th Cir. 1974), the Ninth Circuit upheld an ordinance which permitted only single-family dwellings on residentially zoned property and thus practically prevented the poor from living in the community. In *Petaluma,* the court noted that the zoning plan required that houses be equally divided between single-family and multi-family and that a certain percentage of the units be constructed specifically for low and moderate-income persons.

[55]Sloane v. Dixie Gardens, Inc., 278 So. 2d 309 (Fla. Ct. App. 1973) (fees for garbage collection services).

[56]Kesler & Sons Constr. Co. v. Utah State Division of Health, 513 P.2d 1017 (Utah 1973).

[57]S. 268, 93d Cong., 1st Sess. (1973); H.R. 10,294, 93d Cong., 2d Sess. (1974). The Senate Bill was passed on June 21, 1973, but its House of Representatives counterpart was reported to the House as amended and no further action was taken. The Senate Bill was sent back to the Committee on Interior and Insular Affairs and it is the author's expectation that it will not be brought out again in the near future.

uniform land use regulation standards.[58] In this assistance to the states, the Bill requires that the state plan be designed to develop and maintain sound policies and coordination procedures with respect to federally conducted and assisted projects on non-federal lands having land use implications.[59]

The Environmental Protection Agency is also concerned with land use regulation. For example, it has attempted to control air pollution caused by automobiles in cities, shopping centers, apartment complexes, and industrial developments.[60] Furthermore, recently enacted federal legislation by HUD requiring federal flood insurance on any federally insured mortgage has established very stringent standards for shoreline, lakeside, and streamside development.[61]

State legislation has also been forthcoming. For example, each session of the Indiana General Assembly proposed a statewide planning act,[62] and most recently a regional planning act was enacted[63] resulting in the creation of an eight-county regional planning authority called Hoosier Heartlands.

Additionally, the American Law Institute, in conjunction with the American Society of Planning Officials, has been working for several years on a Model Land Development Code, which has reached a stage of printed fruition.[64] Discarding the complicated tautology of the traditional zoning codes, such as "variance," "permissive use," and "exception," this Code sets up a land de-

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[58]S. 268, 93d Cong., 1st Sess. (1973). The findings of Senate Bill 268 state:

> The Congress hereby finds that there is a national interest in a more efficient system of land use planning and decision making and that the rapid and continued growth of the nation's population, expanding urban development, proliferating transportation systems, large-scale industrial and economic growth, conflicts in patterns of land use, fragmentation of governmental entities exercising land use planning powers, and the increased size, scale and impact of private actions have created a situation in which land use management decisions of wide public concern often are being made on the basis of expediency, tradition, short-term economic considerations, and other factors which too frequently are unrelated or contradictory to sound environmental, economic, and social land use considerations.

*Id.* § 101(a), *reprinted at* 119 Cong. Rec. 20,632 (daily ed. June 21, 1973).

[59]*Id.* § 202(b)(4), at 20,633.

[60]*See, e.g.*, 40 C.F.R. § 52.22(b) (1974); 39 Fed. Reg. 45,014 (1974).

[61]24 C.F.R. § 203.16(a) (1974).

[62]Ind. S. 423, 99th Gen. Assembly, 1st Sess. (1975) (vehicle bill for regional planning); Ind. H.R. 1114, 99th Gen. Assembly, 1st Sess. (1975) (emergency bill calling for the creation of state and regional land use policies and for increasing the powers of the State Planning Services Agency).

[63]IND. CODE §§ 18-7-1.1-1 to -9 (Burns 1974).

[64]ALI MODEL LAND DEVELOPMENT ACT (Tent. Draft, 1968).

velopment agency with powers and duties enumerated in simplified language and an appeal procedure from its decisions to a specially constructed state agency. Most significantly, it takes land use control on a case-by-case basis out of the legislative arena into a quasi-judicial posture.

Whether the belated efforts of the legal profession, in conjunction with the planners, will provide remedies for the evils presently existing in land use regulations remains to be seen. Given the pre-eminence of federal control, the task of convincing a state body politic that local land use controls should be removed from local control and placed in the hands of a new and untried partisan body is, at best, an awesome one. Land use problems are ever-increasing, however, and if the states do not bring about a catharsis in land use regulation at the local government level, the federal authority will take over.

# Exclusionary Zoning: Will the Law Provide a Remedy?

## I. Introduction

The concept of zoning is relatively new. In fact, not until 1926 did the Supreme Court declare its constitutional validity in the landmark case of *Village of Euclid v. Ambler Realty Co.*[1] With zoning power handed to local governments by *Euclid,* it was only a matter of time until abuses occurred. In recent years, a primary form of abuse known as exclusionary zoning has developed. The purpose of this Note is to provide an overview of the many forms and varieties this type of zoning can assume. However, a true understanding of exclusionary zoning must include more than an examination of its manifestations. Consequently, the reasons for its development, how it is implemented, the responses of the judiciary, and the direction of the law will also be discussed. Once these aspects of the problem have been digested, it will be quite apparent that the legal system has only begun the long and arduous task of forming a viable and acceptable solution. Until such a solution is found, other troublesome issues such as school desegregation and busing, inner-city blight, and waste in our welfare system will continue, for it is submitted that the roots of many of these problems lie in exclusionary zoning.

## II. What Is Zoning?

Zoning has been defined as:

> the division of a city by legislative regulation into districts and the prescription and application in each district of regulations having to do with structural and architectural designs of buildings and of regulations prescribing use to which buildings within designated districts may be put.[2]

The legality of zoning is legislative in nature. The states, under their general police powers, have passed enabling acts which give localities the power to zone.[3] It is important to note that the zoning

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[1]272 U.S. 365 (1926).

[2]Miller v. Board of Public Works, 195 Cal. 477, 234 P. 381, 384 (1925). Another court has held: "The essence of zoning in a city is territorial division according to the character of the lands and structures and their peculiar suitability for particular uses, among other considerations, and uniformity of use within the division." Collins v. Board of Adjustment, 3 N.J. 200, 205-06, 69 A.2d 708, 710 (1949).

[3]A typical example of such an enabling act is N.J. Stat. Ann. § 40:55-30 (1948) which provides:

power can be constitutional only if used to promote public health, safety, morals, or general welfare.[4] The reason for this constitutional limitation is that zoning actually prohibits private owners of land from putting the land to *any* use they desire. In essence, then, a zoning ordinance can deprive an owner of property rights, and even do so without compensation, in violation of the fifth and fourteenth amendments to the United States Constitution. Only when a greater public good[5] arises from a zoning ordinance do courts find it constitutional. Therefore, most zoning litigation is based upon whether an ordinance is in actuality creating a greater public good. As will be illustrated throughout this discussion, the determination of a greater public good is the critical point at which municipalities may abuse their power and zone with the unspoken but underlying purpose of excluding the minorities and the poor. Thus, judicial review of the local ordinance becomes necessary when this abuse is alleged in a complaint.

Why have we developed a system of regulated land uses that runs directly counter to constitutionally protected property rights? The answer to this question is found in this country's change from an agrarian culture, upon which the founding fathers based our constitutional principles, to a highly industralized, extremely mobile, continually expanding society. By the turn of the century, unregulated growth was devastating the landscape and creating

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> Any municipality may by ordinance, limit and restrict to specified districts and may regulate therein, buildings and structures according to their construction, and the nature and extent of their use, and the nature and extent of the uses of land, and the exercise of such authority, subject to the provisions of this article, shall be deemed to be within the police power of the State. Such ordinance shall be adopted by the governing body of such municipality, as hereinafter provided, except in cities having a board of public works, and in such cities shall be adopted by said board.
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> The authority conferred by this article shall include the right to regulate and restrict the height, number of stories, and sizes of buildings, and other structures, the percentage of lot that may be occupied, the sizes of yards, courts, and other open spaces, the density of population, and the location and use of buildings and structures and land for trade, industry, residence, or other purposes.

The constitutional provision authorizing zoning ordinances is N.J. CONST. art. 4, § 6, para. 2. *See also* IND. CODE § 18-1-1.5-10 (Burns 1974).

[4]Nectow v. Cambridge, 277 U.S. 183, 187-88 (1928); Village of Euclid v. Ambler Realty Co., 272 U.S. 365, 395 (1926).

[5]The greater public good can be defined as a desire to promote the public health, safety and welfare, coupled with the realization that private interests must sometimes be subordinated to the needs of society as a whole, to prevent some public evil or to fill some public necessity. *See* Hamilton Co. v. Louisville & Jefferson County Planning & Zoning Comm'n, 287 S.W.2d 434, 436 (Ky. 1956).

health and safety problems.[6] Zoning developed to enable communities to grow in an orderly and healthy manner by limiting or preventing the overlapping of incompatible land uses. In its early stages, therefore, zoning was regarded as a blessing.[7] Certain areas were classified for certain uses, and future growth could be planned and orderly.

The original reasons for the creation of zoning schemes must be remembered if one is to comprehend and appreciate how they could be stretched and twisted over a period of fifty years into justifications for exclusionary zoning. In fact, a majority of courts have upheld justifications of exclusionary zoning practices probably because of adherence to outdated zoning precedents and rules of law under a changing set of circumstances. However, courts are slowly but surely fashioning new legal concepts to meet the times. These new concepts will be discussed at length in the following sections, but first it is necessary to become familiar with established doctrines and attitudes of zoning law.

## III. The Euclid Decision and Its Ramifications

*Village of Euclid v. Ambler Realty Co.*[8] is undoubtedly the most important decision in the field of zoning.[9] *Euclid* established the legal tests to determine the constitutionality of local zoning ordinances, provided attorneys and the courts with an abundance of useful language, and seemed to have so settled the issue of zoning that the Supreme Court left the area untouched from 1928 until 1974.[10]

The *Euclid* case involved a tract of land located between railroad tracks and highways. The owner of the land held it for a number of years, watching its value rise, with plans to sell it later to an industrial concern. However, prior to the time of sale, the Village passed an ordinance restricting the area in which the tract was located to residential use. Consequently, the market value of the land sharply declined, and the owner sought to enjoin the enforcement of the ordinance. He contended that the ordinance deprived him of liberty and property without due process of law

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[6]*See* M. Scott, American City Planning 152-82 (1969); Doebele, Jr., *Key Issues in Land Use Controls* in Urban Land Use Policy 3 (R. Andrews ed. 1972).

[7]For an indication of how rapidly and extensively the concept of zoning grew, see C. Haar, Land-Use Planning 147-48, 165-66 (1959).

[8]272 U.S. 365 (1926).

[9]D. Hagman, Public Planning and Control of Urban Land Development 385 (1973).

[10]In 1928, the Supreme Court reaffirmed the holdings of *Euclid* in Nectow v. Cambridge, 277 U.S. 183 (1928). In 1974, the Court reentered the zoning field in Village of Belle Terre v. Boraas, 416 U.S. 1 (1974).

under the fourteenth amendment and, further, that it denied him equal protection of the laws under the same provision. The Court thus had to decide whether the ordinance was an unreasonable and confiscatory violation of the owner's constitutionally protected property rights under the guise of a police power regulation. After a lengthy discussion of the rapidly changing and complex conditions of the period, and analogizing the need for zoning regulations to the need for traffic regulations once the automobile became widely used, the Court held that, before an ordinance could be declared unconstitutional, its provisions must be "clearly arbitrary and unreasonable, having no substantial relation to the public health, safety, morals, or general welfare."[11] The *Euclid* Court found the ordinance quite reasonable and relevant to the general welfare. The justifications cited for the zoning ordinance, which the Court upheld, were protection of the health and security of children from territory devoted to trade and industry, suppression and prevention of disorder, facilitation of the extinguishment of fires, and expedition of the repair of streets where traffic is the heaviest.[12]

One of the most widely used and fundamental concepts fashioned in *Euclid* has come to be known as the "presumption of validity." The Court stated that if "the validity of the legislative classification for the zoning purposes be fairly debatable, the legislative judgment must be allowed to control."[13] Translated into practical terms, a person wishing to challenge a zoning ordinance in court[14] would have an extremely difficult task, since a municipality's justifications for an ordinance can be held "debatable" in almost every instance. Once the "debatable" threshold determination has been made, *Euclid* states that the ordinance is presumed to be constitutionally valid.[15] Such a presumption is particularly burdensome in exclusionary zoning cases in which a municipality's true reasons for creating an ordinance may never be openly discussed, but in which other fabricated justifications, if "debatable," are permitted to prevail.

The *Euclid* Court also commented on apartment houses and stated that they are very often "mere parasites" and "come very near being nuisances."[16] Municipalities wishing to exclude multi-family dwellings often seize upon this language to bolster their

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[11]272 U.S. at 395.

[12]*Id.* at 391.

[13]*Id.* at 388.

[14]This most often occurs after a variance has been denied by the local zoning board or its board of appeals.

[15]272 U.S. at 388.

[16]*Id.* at 395.

position. Many times, however, the courts deciding multi-family zoning cases fail to take notice of other comments contained in the *Euclid* opinion which limit the applicability of those statements. These limitations will be analyzed in a subsequent section of this Note. Most appropriate at this point is a discussion of the vital changes that have occurred in our society since the date of the *Euclid* decision, for it is the nature of these changes, accompanied by adherence to *Euclidean* principles, which has evolved into exclusionary zoning.

## IV. Rapid Growth and Its Effect: Exclusionary Zoning

In the almost five decades since Justice Sutherland wrote the *Euclid* opinion, two main factors have dramatically affected living habits in America. The first was the upper-class and middle-class exodus to suburbia. The second was a rapid increase in population[17] coupled with the housing industry's inability to keep pace with this extremely rapid growth, which resulted in a serious housing shortage.[18] White, middle-class America moved to the suburbs to escape the problems of the cities — high crime rates, deterioration of the public school systems, congestion and overcrowding — and to satisfy their desires for open space and recreational facilities. As highways improved, speed limits increased, and automobile engines became more powerful, travel from suburban homes to city offices became increasingly easy. Suburbia soon became a mass of autonomous municipalities, each with its own governmental organization, school system, and taxing structure. Metropolitan earnings flowed into suburban governments. Suburban communities began to attract industry to create a wider tax base. Since the bulk of suburban government's revenue is based on a property tax, the game of fiscal zoning emerged. Each suburban division attempted to attract land uses that would increase its property tax collections, including industrial uses, commercial uses, and luxury housing. Uses which would not pay for services the government was required to provide were discouraged. For example, excluding low-income housing would keep the tax base up because the cost of educating the children residing in such housing would be greater than the taxes collected from the assessed value of the property. The greater the success of fiscal zoning, the better the schools could be, the more improved the road system would be, and the "better type" of people the community would

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[17]1975 World Almanac 146 (1974). The population has increased by about eighty million since the time of the *Euclid* decision.

[18]For figures on this shortage, see M. Stegman, Housing and Economics 9-37 (1970).

attract. The suburban communities, indeed, had much to be proud of and, of course, to protect. Exclusionary zoning became the method by which they could achieve this end.

What happened in the cities while this suburban growth was taking place? First, much-needed city tax revenues were diminished since money earned by suburban dwellers from business with the city's permanent residents was being carried off to pay suburban taxes. This led to continual cutbacks in the services the cities could provide, including the quality of education. Second, as suburbia began to attract more and more industry, so too flowed the jobs. However, many city workers could not afford to follow. As an illustration, if a certain industry went to a community which zoned its residential area into minimum four-acre lots, it is readily apparent that the high cost of buying a home on such a large piece of property effectively excluded many potential residents. Yet many suburban communities are so zoned, resulting in increased welfare rolls in the cities, while the outlying areas continue to flourish and even complain of labor shortages.[19] Finally, by using these restrictive zoning measures, suburban areas effectively exclude "undesirables." Consequently, the cities are increasingly inhabited primarily by the poor, who are often members of minority groups.[20] The result is an inner core of the poor and minorities with inferior schools, inadequate housing, and lack of employment, surrounded by predominantly white municipalities with superior schools, an abundance of jobs, and a healthy environment.

This critical situation did not go unnoticed by the federal government. To alleviate the serious housing shortage throughout the nation, the Housing and Urban Development Act of 1968[21] set a goal of twenty-six million housing units to be constructed by 1978, with six million of these units designated for low-income and moderate-income families. The Department of Housing and Urban Development (HUD) also designed special programs to alleviate the poor, minority core situation and to permit people with low incomes to be dispersed throughout the suburbs. Specifically, section 236 of the National Housing Act of 1934, as added by the Housing and Urban Development Act of 1968,[22] was created to encourage developers to build low-income housing by providing

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[19] *See* Lakeland Bluff, Inc. v. County of Will, 114 Ill. App. 2d 267, 271, 252 N.E.2d 765, 767 (1969). Testimony on behalf of the plaintiff revealed that the basic cause of a labor shortage in the Joliet area was the lack of low-cost housing in the area for employees.

[20] B. Siegan, Land Use Without Zoning 173 (1972); U.S. Dep't of Commerce, Statistical Abstract of the United States 4, fig. 3 (1974).

[21] 42 U.S.C. § 1441(a) (1970).

[22] 12 U.S.C. § 1715z-1 (1970).

them with profit incentives.[23] The requirements of the program often dictate that first priority be given to those developers who select sites in the outlying areas.[24] Thus, HUD is embarked upon a policy of low-income housing dispersion by having its attendant burdens shared by all rather than by only the large, core urban areas.

HUD's policy, however, has met with strong resistance in outlying suburban areas which typically object to the construction of high density buildings. These objections are based upon the results that may follow high density housing, such as overcrowded schools and roads, overburdened sewage systems, or reduced aesthetic character. In accordance with these general concerns, communities, under their general welfare power, will often pass zoning ordinances prohibiting multi-unit dwellings. Many times such zoning ordinances "mask an underlying desire to keep poor and minority groups out of the area.[25] Developers who wish to pursue a section 236 housing project most commonly must apply for a variance to the zoning ordinance. Suburban pressures will usually not yield, and the variance will be denied. Undaunted developers must then challenge the validity of the zoning ordinance itself. It is at this point that judicial review and case law can have a profound effect on the future of zoning. Federal policy can do little to change the present course of events, since most zoning power rests autonomously at the local level. Moreover, continued adherence to *Euclidean* zoning principles, with the presumption of validity applying to "debatable" ordinances, means that surface justifications will continue to prevail and the underlying problem may never be resolved.

## V. Exclusionary Zoning

This discussion of exclusionary zoning tactics is premised on the fact that exclusionary zoning has been a product of judicial adherence to the original concepts of zoning encompassed within the *Euclid* opinion, while the social conditions under which these con-

[23]For example, the 1968 Act authorizes periodic interest reduction payments on behalf of the owner of a rental housing project designed for occupancy by lower income families. This is accomplished by making monthly payments to the mortgagee to reduce the owner's interest payments from the market rate. The owner must then pass the benefit of this interest reduction to its low income tenants in the form of lower rents. The program also provides for federal insurance of private mortgage loans. *Id.*

[24]Those developers who propose projects outside areas of total or substantial minority concentration will receive a "superior" rating among the applications submitted. 24 C.F.R. § 200.700-.710 (1974).

[25]C. Edson & B. Lane, A Practical Guide to Low and Moderate Income Housing 9:2 (1972).

cepts were formulated have rapidly changed. Exclusionary zoning can be defined as a means by which a local government can exclude those whom the community does not wish to have as residents by creating zoning ordinances which frustrate the ability of "undesirables" to move into the community. This is accomplished under the guise of the general police powers promoting the health, safety, morals, and general welfare of the inhabitants. In formulating this definition, an attempt has been made to grasp the reality of the situation. Certainly a municipality, and naturally its solicitor, would find such a definition outrageous since they would never admit to the practice of zoning for exclusionary purposes. One charged with exclusionary tactics would, for example, justify passage of an ordinance restricting multi-unit dwellings by proffering such explanations as maintaining property values, avoiding burdens on present sewage systems, or preventing overcrowding of schools. In presumption of validity jurisdictions, a party charging exclusionary tactics would have the burden of refuting those justifications before the ordinance could be declared constitutionally invalid. Such a burden is, indeed, heavy. The question is whether such justifications can be presumed valid given present growth patterns and population pressures. The answer must be that they cannot.

Some of the exclusionary tactics used by the suburbs are aimed directly at the poor, the blacks, and other minority groups. However, this motive will rarely be found in the text of the ordinance or the transcripts of zoning board meetings, or voiced by suburban zoning officials. The ordinance will almost always appear neutral on its face and "debatable."

The exclusion of multi-unit dwellings is probably the most widely used method of exclusionary zoning. The municipality passes an ordinance which limits its residentially zoned areas to single-family houses. In essence, apartment dwellers are zoned out of a particular locality.[26] The justification usually stated is that large multi-unit dwellings will not pay their way and will put a strain on existing services, roadways, and schools. In many intances this will be true, especially in small towns, but it is not true of every municipality which uses this justification. Each case should be examined in light of the particular surrounding circumstances. Frequently, an ordinance excluding apartments is directly aimed at excluding apartment dwellers. Such people are often viewed as "transients" who develop no pride in or concern

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[26]The exclusion of multiple unit dwellings means that nowhere in the community may an apartment house be built. It does *not* mean that they are only restricted to certain areas within a community. This distinction is extremely critical for a full comprehension of exclusionary zoning.

for their community. This view ignores the fact that many apartment dwellers are newlyweds or elderly persons on fixed incomes who usually have a concern for their community. The younger couples may have jobs within the area and may eventually raise children and purchase homes in the community. The older apartment residents may be retirees who wish to live out a peaceful and safe life, and so they too may have an interest in the soundness and well-being of the area.

There is also the widely held misconception, emanating from the nineteen-twenties, that apartments necessarily breed overcrowded and congested living conditions. In *Euclid,* which is often cited by local governments to bolster their positions in creating ordinances excluding apartments, the Court noted:

> [T]he coming of one apartment house is followed by others, interfering by their height and bulk, with the full circulation of air and monopolizing the rays of the sun which otherwise would fall upon smaller houses, and bring, as their necessary components, the disturbing noises incident to increased traffic and business, and the occupation, by means of moving and parked automobiles, of larger portions of the streets, thus detracting from their safety and depriving children of the privilege of quiet and open spaces for play, enjoyed by those in more favored localities — until finally, the residential character of the neighborhood and its desirability as a place of detached residences are utterly destroyed. Under these circumstances, apartment houses, *which in a different environment would be not only entirely unobjectionable but highly desirable, come very near being nuisances.*[27]

A close reading of *Euclid,* however, reveals that apartment houses are often mentioned in the same context as hotels, thus implying that in 1926 the two types of structures had similar physical characteristics. This is not always the case today. Apartment houses are often of the garden variety, that is, only two or three stories tall. The *Euclid* Court was certainly not addressing itself to this type of housing. Thus, if a community wished to avoid the results contemplated by *Euclid,* it could zone only for garden-type apartments, specify distances between each structure, require adequate parking facilities, and provide for wide-open areas. In fact, the *Euclid* Court actually suggested the above alternative when the Court stated that in different circumstances apartment houses "would be not only entirely unobjectionable but highly desirable."[28] Zoning out apartments completely ignores the

[27] 272 U.S. at 394-95 (emphasis added).
[28] *Id.* at 395.

harsh realities of an ever-growing population, the extreme shortage of housing, and the rights of people to live where they want in the best housing they can afford.

A second popular tactic used to accomplish exclusionary zoning is termed "large-lot" zoning. This entails zoning residential areas into minimum lot sizes of two or three acres. The suburban municipality can thus limit the total amount of housing, and the type of people, in the community, since large lots are more expensive than small ones. In many instances, such planned future growth is certainly within the "general welfare" of the people. The need to forecast future growth rates in order to provide adequate schools, sewage disposal, transportation, and social programs is a goal that should be actively pursued by all levels of government, especially state and local. On the other hand, a suburban community cannot stand in the path of increasing population pressures by large lot zoning. As the demand for housing increases, it cannot be so necessary to the general welfare that each unit be three acres apart.[29]

Another method utilized in exclusionary zoning is the prohibition of mobile homes. In other words, people desiring to live in this type of housing are forced to move where it will be accepted. Many communities have zoning ordinances which exclude mobile homes entirely. Again, the motives for these ordinances appear to involve a misconceived stereotyping of the appearance of such homes, their effect on bordering property values, and the kind of occupants they attract. Another possible motive may be that mobile homes may not be taxable as real property[30] and the local government would take almost a total loss on services, especially educational services, provided to the occupants. With the present shortage of low-income and moderate-income housing, this type of structure can help fill the gap between the huge demand and the small supply of new houses.[31] Today's mobile homes must also be recognized as drastically different from the "trailer" type homes of thirty years ago.[32] Also, there is no reason to believe that once

[29]Certainly some responsibility to accommodate an increasing population must be recognized, and in the Pennsylvania case of National Land Inv. Co. v. Kohn, 419 Pa. 504, 215 A.2d 597 (1965), such a duty was acknowledged.

[30]For a breakdown of how the states regard mobile homes for purposes of taxation, *see* M. Drury, Mobile Homes 46-52 (1972) [hereinafter cited as Drury].

[31]In fact, many people choose to live in mobile homes. *See* Elias, *Significant Developments and Trends in Zoning Litigation*, in Institute on Planning, Zoning and Eminent Domain 22 (Southwestern Legal Foundation 1973) [hereinafter cited as Elias].

[32]The outward appearance of mobile homes has changed from the plain, expressionless masses on wheels to attractive homelike structures. Industry-

mobile homes are permitted within a community, chaotic residential growth will occur. Nothing prevents the locality from restricting mobile homes to mobile parks which, in turn, can be required to be landscaped and to have paved roads, recreational facilities, setback requirements, and a maximum number of units. That is, zoning regulations can be used to create an appealing environment for this type of housing and thus to alleviate the fears of reduced property values and aesthetic injury. With the aforementioned inner-city problems, and the concomitant movement of industry to the suburbs, it is unlikely that total exclusion of mobile homes is promotive of the "general welfare."

Exclusionary zoning may also be accomplished by following administrative procedures that create long and costly delays and thereby discourage developers, prospective tenants, or mobile home dwellers from attempting to live in or build new low-income and moderate-income housing within the community.

What is evident from the above discussion is the increasing resistance, via exclusionary zoning, of neighborhood groups and their suburban governments to permit the minorities and the poor to live within their communities, to find or retain employment, and to enjoy the benefits the community has to offer. This is not to advocate a massive rush to open up the suburbs to the inner-city dwellers by complete abolition of zoning, but it is an appeal to ease some of the more rigid restrictions so that a better balance can be struck, thereby allowing the cities to be strong and viable entities and allowing the suburbs to retain their traditional characteristics. How the legal system has dealt with this suburban resistance is examined in the remainder of this Note.

## VI. The Litigation Process

The judiciary enters this legislative area when it is alleged that a zoning ordinance violates constitutional property rights. The Supreme Court in *Euclid* held that property may be zoned if done in a reasonable manner, that is, for the general welfare. The

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wide regulations require them to be equipped with adequate plumbing and sanitation facilities. In the past, the absence of these facilities often created eyesores directly outside each unit. Also, most of today's mobile homes are only mobile in the sense that they are constructed at the factory and then moved to a permanent tract. Once there, they no longer remain on wheels.

In 1963, the two trade associations of the mobile home industry established the first self-imposed national standards in the housing industry. The Mobile Home Manufacturer's Association and the Trailer Coach Association can be commended for establishing requirements that have made noticeable improvements in the overall quality of the mobile home. See Drury, *supra* note 30, at 110-11, for details of the regulations.

litigation process, therefore, will focus on the reasonableness of the ordinance in relation to the health, safety, morals, or general welfare of the people whom it regulates. Since the *Euclid* presumption of validity attaches once it is shown that the ordinance is at least "debatable," a plaintiff must show that a zoning restriction affecting his property is unreasonable and unrelated to the general welfare in violation of his constitutional rights. To strengthen his case, a plaintiff may also allege that the zoning ordinance is in violation of other constitutionally and statutorily protected rights. For example, an ordinance may have some effect on racial mobility.

The most common forms of attack come under the due process clause of the fifth and fourteenth amendments and the equal protection clause of the fourteenth amendment. The plaintiffs are usually developers under section 236 programs designed to stimulate dispersion of low-income housing—a policy which frequently clashes with local zoning ordinances and practices. In many cases, potential tenants of the proposed housing also join as plaintiffs and broaden the issues involved beyond those concerning the developer to ones touching on public policy. It is in this area that the judiciary can have a significant impact on exclusionary zoning. A brief introduction to the arguments most frequently used will aid in the later case analysis.

### A. *The Due Process Argument*

The United States Constitution prohibits deprivation of property without due process of law. The due process argument focuses on the traditional rights in property, the reasonable limitations upon those rights under the concept of zoning as pronounced in *Euclid,* and the abuse of the local legislative power in creating unreasonable zoning laws not related to the general welfare.

### B. *The Equal Protection Argument*

In recent years, equal protection has become one of the most widely used doctrines in the presentation of an exclusionary zoning case. The fourteenth amendment states that no state shall "deny to any person within its jurisdiction the equal protection of the laws." The development of this clause as applied to exclusionary zoning has been from a rather narrow to a broader interpretation of what constitutes a denial of equal protection. It is important to recognize that this expansion is occurring, but it should also be noted that its pace has been sluggish since most courts tenaciously cling to the traditional *Euclidean* concepts.

The equal protection clause was first utilized in cases in which owners were denied uses of land that were allowed to others.

The clause was appropriate in these instances and, hence, there was little reluctance by the courts to apply it when such occasions arose.[33] Typically, an area was zoned for a particular purpose, but a municipality would allow another use in that sector.[34] A set of criteria was used upon which the decision was based. If another person then desired to use the same area in a manner not provided for in the zoning laws, and the municipality refused to allow the use, the person could bring an equal protection challenge to determine whether the municipality was consistent in the application of the criteria.

The next step in the evolution of the equal protection argument came on those occasions when zoning laws were directly motivated by desires to exclude blacks and other minority groups.[35] Once that motivation was factually established by the plaintiffs, discrimination was obvious, and a claim of unequal protection of the laws was upheld.

Exclusionary zoning laws, however, became very sophisticated. Rarely was discriminatory language or innuendo employed, and discriminatory motive was readily refuted by the zoning authorities. Yet the equal protection clause could still be employed to challenge a zoning ordinance if it could be shown that the *effect* of the law was discriminatory. As one court aptly stated:

> If proof of a civil right violation depends on an open statement by an official of an intent to discriminate, the Fourteenth Amendment offers little solace to those seeking its protection. . . . [I]t is enough for the complaining parties to show that the local officials are *effectuating* the discriminatory designs of private individuals.[36]

Attendant with the urban-suburban dichotomy, the federal policy of dispersion, and the recalcitrance of suburban communities to submit to any outward pressures as shown by their exclusionary zoning tactics, the logical progression of the equal protection clause should turn toward affording a remedy to the class of citizens being excluded, namely, the poor. Whether such an amorphous class can come within the fourteenth amendment is the controversy that presently rages in the courts. Does the fact that most poor people are members of minority groups carry any legal significance? Should the poor as a class be a "suspect"

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[33]For a recent federal case applying this rule, *see* City of Miami v. Woolin, 387 F.2d 893 (5th Cir. 1968); *cf.* Chicago Title & Trust Co. v. Village of Wilmette, 27 Ill. 2d 116, 124-26, 188 N.E.2d 33, 38 (1963).

[34]This is commonly termed a legal non-conforming use.

[35]See text accompanying notes 74, 76 & 79 *infra*.

[36]Dailey v. City of Lawton, 425 F.2d 1037, 1039 (10th Cir. 1970) (emphasis added).

classification triggering a strict scrutiny test whereby a compelling interest of the community must be shown before a zoning ordinance will be allowed to stand? Is the right to live wherever one chooses a fundamental right which will also trigger the strict scrutiny test? In essence, do the suburban exclusionary tactics deny the poor the equal protection of the laws by preventing them from enjoying the same benefits enjoyed by those in the suburbs? Does the power to zone, with these exclusionary results, come within the concept of the general welfare? These are the equal protection questions now being confronted by the courts. How the case law develops will, in part, determine the future parameters of a municipality's power to zone.

### *C. The Supremacy Clause*

Article VI, clause 2 of the United States Constitution provides yet another basis for attack upon exclusionary zoning laws, but a supremacy clause argument has been less successful, thus far, than an argument based upon due process or equal protection. Yet, with new HUD regulations, this could become an important legal weapon in an action to declare a local zoning ordinance invalid. The reasoning behind the use of the supremacy clause is that HUD has formulated a policy of dispersion which is to be implemented by giving priority approval to developers requesting federal funds for low-income housing, if the facilities are placed in suburban areas.[37] Local exclusionary zoning ordinances preventing developers from doing this are arguably in violation of the supremacy clause. This thesis was used by the trial court in *Ranjel v. City of Lansing*[38] to declare invalid a referendum which would have prevented an amended zoning ordinance allowing low-income housing in a predominantly white neighborhood. However, on appeal,[39] the Sixth Circuit stated that since HUD's policy was not contained in the Federal Register, and did not have presidential approval, it did "not rise to the dignity of federal law."[40] Therefore, the referendum was not in violation of the supremacy clause. This decision has effectively arrested the use of the supremacy clause, but it is arguable that its future use is merely dependent on a regulation being officially issued, presidential approval, or legislation by Congress implementing HUD's policy.

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[37]HUD Low-Rent Housing Manual, § 205.1, para. 4g. *See* text accompanying notes 22-24 *supra*.

[38]293 F. Supp. 301 (W.D. Mich.), *rev'd*, 417 F.2d 321 (6th Cir. 1969).

[39]417 F.2d 321 (6th Cir. 1969).

[40]*Id.* at 323.

## VII. Has Case Law Shown a Way?

While the *Euclid* decision has long been an almost sacred guide in defining the limits of the zoning power, and zoning ordinances created under the guidelines of the decision have been virtually invulnerable if any reason could be found to uphold them, recently the *Euclidean* barriers appear to be weakening. An ambitious federal housing policy, shortages of housing, urban sprawl, and shifting industrial sites are a few of the pressures that are eroding the barriers. In jurisdictions most affected by these forces, the judiciary has been willing to reexamine traditional theory and adopt new principles.

### A. An Alternative Suggestion

If *Euclid* can be distinguished from an exclusionary case, doctrines such as the presumption of validity will be considerably weakened, thereby undercutting much of the forcefulness in a municipality's justifications for an exclusionary ordinance. *Euclid* can be viewed as merely approving a general zoning process which limits the intrusion of industrial and business development into residential areas. But present exclusionary zoning is attempting to limit certain types of residences in *residentially* zoned areas. A careful reading of the *Euclid* opinion, along with its general tone, indicates that the principles it advances should not be used for such purposes. The dicta concerning apartment houses is certainly not applicable to the many varieties of apartments that can be built today without the tragic consequences Justice Sutherland envisioned.[41] In addition, the opinion contains many statements which suggest that the zoning principles it advances are not to remain static but are to adjust to changing conditions. First, the Court justified the disputed regulation for reasons analogous to those justifying traffic regulations, which reasons would have been regarded as arbitrary and unreasonable just fifty years earlier.[42] The Court held that although "the meaning of constitutional guarantees never varies, the scope of their application must expand or contract to meet the new and different conditions" that constantly develop in a changing world.[43] Why this language has not been extracted from the opinion and used to attack local regulations that can no longer be constitutionally justified is a mystery. It is only a matter of redefining the scope of the zoning power relative to a vastly changed environment. Some courts have, indeed, accomplished this by focusing solely on the due process

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[41]See notes 26-28 *supra* and accompanying text.

[42]272 U.S. at 387.

[43]*Id.*

and equal protection arguments.[44] The same end could be achieved, and the forcefulness of the results compounded, if *Euclid* were distinguished and its language used to support new parameters of zoning authority. In that way, the reliance on *Euclid* by the majority of the courts could be diminished at a quicker pace than at present.

### B. *An Emerging Theory*

Judicial awareness of exclusionary tactics began to surface about twelve years ago in dissenting opinions in zoning cases.[45] Although dissents do not set policy or create law, they may portend later judicial creativity. However, the judiciary is still extremely reluctant to intervene, since the enactment of zoning ordinances is legislative in nature, and the purpose of the courts is not to rule on the wisdom of a legislative enactment. This current of judicial thought is aptly enunciated in *Robinson v. City of Bloomfield Hills*,[46] in which the court announced that it would "not sit as a super-zoning commission."[47] For alleged abuses, the court held, the remedy is in the ballot box, not in the courts.[48] The ordinance comes to the court "clothed with every presumption of validity."[49] These statements, obviously *Euclidean* in nature, might be categorized as judicial hedging. There are serious legal questions involved in challenges to zoning ordinances, especially ordinances designed to exclude certain groups. An attitude that evades this responsibility by suggesting that a remedy to these disputes can be found by relying on the ballot box is absurd. The majority of suburban communities prefer exclusionary zoning tactics, though they may not recognize them as such, as a means of preserving their community character and style of living. Consequently, their elected zoning officials will always represent that viewpoint. What kind of relief is there in telling the excluded groups to wait for the next election? The courts obviously have jurisdiction over these matters, since the disputes involve constitutional property rights, due process infringements, and denials of equal protection. Although an ordinance may be valid, the courts should at least examine the issues presented.

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[44]See discussion of due process and equal protection arguments at text accompanying notes 60-108 *infra*.

[45]*See* Vickers v. Township Comm., 37 N.J. 232, 252, 181 A.2d 129, 140 (1962) (Hall, J., dissenting). *See also* Lionshead Lake v. Wayne Township, 10 N.J. 165, 181-84, 89 A.2d 693, 701-02 (1952) (Oliphant, J., dissenting).

[46]86 N.W.2d 166 (Mich. 1957).

[47]*Id.* at 169.

[48]*Id.*

[49]*Id.* at 170.

One of the earliest attempts at judicial recognition of exclusionary schemes came in the New Jersey case of *Vickers v. Township Committee.*[50] The attempt failed in a 5-2 decision, but the dissenting opinion has become a landmark in exclusionary zoning litigation. The case arose on a challenge to the validity of a township zoning ordinance amendment which prohibited trailer camps and trailer parks in an industrial district. In effect, this meant that trailers were prohibited anywhere in the township. The plaintiff, who wished to develop a trailer camp, tried to show that the trailer camp would have no adverse economic effect upon any surrounding areas. The township maintained that it would be unattractive and would reduce neighboring property values, and that future growth plans provided for a strictly industrial area. Thus, the issue was whether the township had the power to bar trailer camps within its boundaries. The trial court held that the prohibition of trailer camps could be legislated. The appellate court reversed and held that the zoning ordinance must be set aside as an unreasonable and arbitrary exercise of the zoning power.[51] The New Jersey Supreme Court upheld the trial court, stating that a court could "act only if the presumption in favor of the validity of the ordinance is overcome by an affirmative showing that it is unreasonable or arbitrary."[52] The court found that the plaintiff had not overcome such a presumption, and that a municipality did not need to provide a place for every use and could exclude those it believed repugnant to its planning scheme.

The two dissenting justices, however, strongly disapproved of the majority's reasoning. The opening statement of the dissent indicates the vigorous tone of the objections.

> The majority decides that this particular municipality may constitutionally say, through exercise of the zoning power, that its residents may not live in trailers—or in mobile homes . . . . I am convinced such a conclusion in this case is manifestly wrong. . . . The import of the holding gives almost boundless freedom to developing municipalities to erect exclusionary walls on their boundaries, according to local whim or selfish desire, and to use the zoning power for aims beyond its legitimate purposes. Prohibition of mobile home parks, although an important issue in itself, becomes, in this larger aspect, somewhat a symbol.[53]

The dissenters pointed out that the township was on the outer ring of the urban centers of Philadelphia and Camden, and that

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[50] 37 N.J. 232, 181 A.2d 129 (1962).
[51] 68 N.J. Super. 263, 172 A.2d 218 (1961).
[52] 37 N.J. at 242, 181 A.2d at 134.
[53] *Id.* at 252-53, 181 A.2d at 140.

there was significant industrial development occurring in the locale with an inevitable population migration into the area. The justices further reasoned that the intelligent application of constitutional law to planning law could only be understood by an analysis of particular ordinances in relation to the whole background of the "changing physical, economic, and social environment."[54] They felt that judicial scrutiny had become too superficial and one-sided under *Euclidean* doctrine and had ignored the realities of the day. What constitutes the general welfare "transcends the artificial limits of political subdivisions and cannot embrace merely narrow local desires."[55] This viewpoint was a radical departure from customary zoning principles. It advanced the theory that if the valid authority for zoning law is based on promoting the "general welfare," that term must embrace a regional rather than an artificial political perspective. There was a sense that the justifications used to raise the presumption of validity were actually shielding an underlying exclusionary attitude towards mobile homes. The dissenters rejected the notion that promoting the general welfare was automatically what the municipality said it was, and characterized the exclusionary tactics as economic segregation.

The reasoning in the *Vickers* dissent was far ahead of its time, but it vividly describes a current vein of thought in zoning law. The dissenters maintained that the factors used by the township to justify their amended zoning ordinance created "Chinese walls on the borders of roomy and developing municipalities"[56] which, in effect, brought about community-wide segregation by keeping out all but the "right kind" of people and providing for only a certain type and cost of dwelling. To them, zoning could not be deemed proper if used "to control who the residents of your township will be."[57] Asserting that mobile homes are perfectly respecable and healthy, and a useful form of housing chosen by several million people, and that municipalities "should stop acting on the basis of old wives' tales,"[58] the dissenters concluded that the total restriction of mobile homes was unreasonable and arbitrary.

The dissent in *Vickers* represents a view which recognizes that the social effects of exclusion are highly undesirable, and that the judicial role should be more probing in evaluating what constitutes a valid exercise of the zoning authority based on the nebulous concept of the general welfare. The dissenters step

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[54]*Id.* at 255, 181 A.2d at 142.
[55]*Id.* at 263, 181 A.2d at 146.
[56]*Id.* at 266, 181 A.2d at 147.
[57]*Id.*
[58]*Id.* at 267, 181 A.2d at 148.

outside municipal boundaries and evaluate an exclusionary municipal zoning ordinance "on the basis of zoning allocations throughout the region in which the challenged municipality is located."[59]

Three years later the Pennsylvania Supreme Court applied the principles of the *Vickers* dissent in *National Land & Investment Co. v. Kohn.*[60] In *Kohn,* the issue concerned the validity of an ordinance which established a minimum lot size of four acres. The plaintiff wanted to construct a single dwelling on a one-acre lot. The community maintained that the four-acre minimum was necessary for proper sewage disposal and pollution control, and to prevent undue burdens on the road system. The *Kohn* court resolved this dispute by first pointing out the crucial importance of the location of Easttown Township, the jurisdiction at issue. The Pennsylvania Supreme Court, after noting that the township was directly in the path of population pressures approaching from two directions, Philadelphia on the east and Valley Forge on the west, found that the four-acre minimum was directed more toward retaining the rural character of the township than toward the reasons the township advanced. Expert testimony revealed that the fears voiced by the local zoning authority would not be realized even if the minimum lot size was reduced to one acre. "At some point along the spectrum, however, the size of lots ceases to be a concern requiring public regulation and becomes simply a matter of private preference."[61] The court adopted the reasoning of the *Vickers* dissent and held that a township cannot stand in the way of a growing population searching for comfortable places to live:

> A zoning ordinance whose primary purpose is to prevent the entrance of newcomers in order to avoid future burdens, economic or otherwise, upon the administration of public services and facilities cannot be held valid.[62]

Thus, in Pennsylvania, under *Kohn,* it is no longer enough for zoning to be reasonable in relation to the needs of only the political subdivision. The needs of the entire area must be considered.

Pennsylvania reaffirmed these basic tenets in two 1970 decisions. *Appeal of Kit-Mar Builders, Inc.*[63] dealt with a zoning ordinance delineating a two-acre minimum lot size. The restriction was declared unreasonable in light of the surrounding circumstances,[64] and again the Pennsylvania Supreme Court found

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[59] D.R. Mandelker, The Zoning Dilemma 11 (1971).

[60] 419 Pa. 504, 215 A.2d 597 (1965).

[61] *Id.* at 524, 215 A.2d at 608.

[62] *Id.* at 532, 215 A.2d at 612.

[63] 439 Pa. 466, 268 A.2d 765 (1970).

[64] The primary justification for the zoning ordinance was that lots of a smaller size would create sewage problems, yet the standards contained

that burdens on an existing sewage system could not justify exclusionary zoning.[65] A village can protect itself by conditioning a building permit upon a general assessment for sewage reconstruction. Thus, a presumption of validity can no longer attach to a sewage burden justification. The Pennsylvania Supreme Court refused to allow a municipality to exclude people instead of making community improvements:

> [C]ommunities must deal with the problems of population growth. They may not refuse to confront the future by adopting zoning regulations that effectively restrict population to near present levels. It is not for any given township to say who may or may not live within its confines, while disregarding the interests of the entire area.[66]

The other Pennsylvania decision maintaining that a regional perspective must be applied when creating zoning ordinances or, for that matter, adjudicating their validity, is *Appeal of Girsh*.[67] A zoning law that did not prohibit, but failed to provide for, apartment land use was held unconstitutional as an unreasonable land use restriction. In fact, in considering the location of the municipality as the next logical place for population growth, the Pennsylvania Supreme Court stated that the municipality could not freeze its present population level by limiting residentially zoned areas to single-family dwellings.[68] A zoning scheme without a reasonable provision for apartment dwellings would be unreasonable per se. In other words, the court imposed an affirmative duty on the municipality to provide for apartment housing. In answering objections that such structures would destroy the attractive character of the area, the court replied that aesthetic zoning was not a valid exercise of the police power. The township could protect itself by requiring the apartments to be built "in accordance with reasonable set-back, open space, height, and other light-and-air requirements, but it cannot refuse to make any provision for apartment living."[69] It is evident that the *Girsh* court perceived that the township was not as fearful of apartments, in and of themselves, as it wished the court to believe.

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in the Pennsylvania laws indicated that the required absorption area for a three-bedroom house on a lot with the minimum acceptable percolation rate would be only slightly more than 1,000 square feet. This fact, coupled with the two-acre minimum lot requirement, in an area subjected to rapid population expansion, led the court to hold the minimum lot size unreasonable. *Id.* at 477-78, 268 A.2d at 770.

[65]*Id.* at 472, 268 A.2d at 767.

[66]*Id.* at 474, 268 A.2d at 768-69.

[67]437 Pa. 237, 263 A.2d 395 (1970).

[68]*See generally* Sager, *Tight Little Islands: Exclusionary Zoning, Equal Protection, and the Indigent*, 21 STAN. L. REV. 767 (1969).

[69]437 Pa. at 245, 263 A.2d at 399.

The court felt that the exclusionary purpose went deeper than prohibiting multi-family dwellings. "In refusing to allow apartment development as part of its zoning scheme, appellee has in effect decided to zone out the people who would be able to live in the township if apartments were available."[70]

In 1971, the reasoning of these three Pennsylvania cases influenced a New Jersey court. In a period of only nine years, the dissent in *Vickers* had become majority reasoning in the case of *Oakwood at Madison, Inc. v. Township of Madison.*[71] The case dramatically illustrates the proposition that zoning laws cannot be used to restrict inevitable growth in a particular region, since this would not promote the general welfare. In *Oakwood* the town's population had grown from 7,366 in 1950 to 48,715 in 1970. The zoning ordinance under attack set minimum floorspace requirements, set one-acre and two-acre minimum lot sizes, and substantially limited multi-family dwellings by limiting the number of individual units that could be built in a year. Under the ordinance, the minimum purchase price for a home in this area was estimated at $45,000. The plaintiffs owned vacant land in the area and were seeking to build low-income housing, since much new industry had recently come to Madison Township. Plaintiffs also included six low-income individuals who were seeking housing inside the township. The township urged that it was safeguarding against flood and surface drainage problems by zoning into districts with low population density. But the Superior Court of New Jersey held, in the absence of any record by which they could substantiate this claim, that the zoning ordinance was invalid for failing to promote a reasonably balanced community in accordance with the general welfare. The court found that a municipality must assume an obligation to meet not only the housing needs of its own population, but that of its region as well. Indeed the court ruled that the "general welfare does not stop at each municipal boundary."[72]

What has emerged from these few opinions is the obligation of a municipality, when legislating zoning ordinances, to consider the regional needs of an area, rather than only the interests within its political subdivision. If a community neglects this task, its laws may be declared invalid as an unreasonable restriction of property use in violation of the due process clause. The power to zone can be legitimate only if used to promote the general welfare. Under these holdings, the general welfare is *regional* in nature. Implicit in these decisions is the desire of the judiciary to allow people the basic right to live wherever they may choose,

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[70]*Id.*

[71]117 N.J. Super. 11, 283 A.2d 353 (1971).

[72]*Id.* at 20, 283 A.2d at 358.

to relieve artificially induced population pressures, and to prohibit local governments from using exclusionary measures to evade the burdens created by low-income housing, which burdens, until recently, have been confined to the inner cities. These decisions by a few jurisdictions, weakening exclusionary barriers, also focused on benefiting the poor and the minorities who have been denied many of the basic rights others take for granted, such as selecting where and in what mode they will live.

### C. *The New Equal Protection*

Beyond a challenge that a zoning law is not a reasonable exercise of the police power in furtherance of the general welfare is the fact that the operation of such laws can be patently discriminatory. On this basis, both the racial minorities and the poor have been directly affected. Therefore, they often seek redress under the equal protection clause.[73] The tide of litigation under this clause ranges from cases alleging racially motivated discrimination to those challenging zoning ordinances that discriminate against the poor. Between these two extremes is the shady area in which the poor and the racial minorities are so inextricably coupled that the basis for a court's decision is difficult to extrapolate.

The complainants, a construction company and a potential black tenant, in *Dailey v. City of Lawton*,[74] brought an action to enjoin the city from denying a zoning change for the construction of low-income housing. The City of Lawton, Oklahoma, tried to justify its denial on the basis of overcrowding of local schools and recreational facilities, and overextension of fire-fighting capabilities. The federal district court found from the facts that the ordinance was racially motivated, and that there was not enough support for the city's justifications to outweigh the racial prejudice.[75] For example, the facts showed that other property in the area received the permissive zoning sought by the plaintiffs, and that the petitions opposing the zoning change were signed only by whites. The city maintained that no such motive was evident on the face of the zoning ordinance, but the court stated that it was sufficient for complainants to show that the effect of the ordinance was discriminatory. This they did, and the ordinance was declared violative of the fourteenth amendment.

In *Crow v. Brown*,[76] the problem of attempting to effectuate the federal policy of low-income housing dispersion was cen-

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[73]See note 33 *supra* and accompanying text.

[74]425 F.2d 1037 (10th Cir. 1970).

[75]296 F. Supp. 266 (W.D. Okla. 1969).

[76]332 F. Supp. 382 (N.D. Ga. 1971), *aff'd*, 457 F.2d 788 (5th Cir. 1972).

tral. Fulton County, situated on the outer rim of Atlanta, had granted a building permit to a developer to construct apartment buildings. When the county zoning authorities later discovered that the developer intended to construct low-income housing, which they secretly feared would draw inner-city blacks, they denied the building permit. The plaintiffs were eligible black persons on the waiting list of the Atlanta Housing Authority for low-rent public housing. The Fulton County Commissioners stated that, when they first changed the zoning ordinance, it was on the basis that "nice" apartments would be built, not low-rent apartments. The court replied that "although the Commissioners say they want only 'nice' apartments . . . it is clear that they are not talking about the physical quality of the building."[77] The court found that, after the county had legitimately zoned the tracts for construction of apartments, to deny access to these particular tenants was violative of the equal protection clause.[78]

When the owners of a particular tract of land in Lackawanna, New York, sought to construct a low-income housing project, the city took measures to frustrate them, one of which was to rezone the tract for a park. In the ensuing litigation, *Kennedy Park Homes Association, Inc. v. City of Lackawanna*,[79] the evidence revealed that blacks and low-income groups had historically been confined to the city's first ward, where a plant of the Bethlehem Steel Corporation was located.[80] The owner's tract was located in a different ward. The court found that the owners were seeking to exercise their constitutional property rights,[81] and that the effect of the city's action was adverse to the enjoyment of those rights. In such circumstances, the court ruled, the city must show a compelling governmental interest to overcome a finding of unconstitutionality.[82] It appears, therefore, that the court was applying a strict scrutiny test when it ruled that the denial of decent housing to low-income[83] and minority families was in violation of the equal protection clause.

[77]332 F. Supp. at 389.

[78]*Id.* at 390.

[79]436 F.2d 108 (2d Cir. 1971), *cert. denied*, 401 U.S. 1010 (1971).

[80]Lackawanna was a three-ward city with 98.9 percent of all its nonwhite citizens living in the first ward. The second ward, with a population of 8,974, had only one nonwhite person, and only twenty-nine nonwhites resided in the third ward. In addition, there were three low-income housing projects in the city—all of which were located in the first ward. 436 F.2d at 110.

[81]That is, the "freedom from discrimination by the States in the enjoyment of property rights." *Id.* at 114, *quoting from* Shelley v. Kraemer, 334 U.S. 1, 20, 68 (1948).

[82]436 F.2d at 114.

[83]*Id.* at 109 (those of low income specifically referred to).

These last few cases seem to indicate that the use of the equal protection clause may be based on more than racial discrimination. The innumerable statements referring to those receiving low incomes, the "class" of people who live in apartments, and the "type" who have mobile homes suggest that the holdings could apply to the poor as well. Whether or not the equal protection clause can be used to invalidate economic segregation via zoning ordinances is a step most courts prefer not to take. Nevertheless, some willingness has appeared.

The case of *Southern Alameda Spanish Speaking Organization v. City of Union City*[84] speaks directly to the applicability of the equal protection clause to protect against zoning used to exclude the poor. Yet, a final decision on that issue was not made by the court, since the case dealt with the legality of a referendum having to do with the zoning scheme, rather than with the legality of the scheme itself.

SASSO had requested that a zoning ordinance be changed so that the construction of federally financed, low-income housing would be permissible in Union City. The request was granted. Thereafter, some disturbed citizens, realizing that low-income housing would attract Mexican-Americans, initiated a referendum and overrode the zoning grant.[85] SASSO sought an injunction directing Union City to implement the zoning change notwithstanding the referendum. SASSO first argued that the referendum would permit the electorate to regulate zoning without following the general welfare standards laid down by the United States Supreme Court. Since the referendum did not allow for these safeguards, it left zoning to the capricious and arbitrary whims of the public. The Ninth Circuit rejected this argument and held that the referendum was neutral on its face and did not zone or regulate land use; it merely stayed the zoning ordinance adopted by the council.[86] But is this explanation sound? If the court's reasoning were carried to its logical conclusion, the court would have to accept SASSO's contention. With the use of the referendum, the citizens of Union City could continually approve or disapprove of granted amendments until the end they sought was effectively achieved, that is, the exclusion of those they did not desire. Is this not relegating the zoning power to the preferential whims of the people?

A crucial point in the case, however, is the fact that the judges acknowledged that SASSO did have a basis for an equal

[84]314 F. Supp. 967 (M.D. Cal.), *aff'd*, 424 F.2d 291 (9th Cir. 1970).

[85]California law provides for this measure under CALIF. ELECTION CODE §§ 4051-52 (1961).

[86]424 F.2d at 294.

protection argument. They noted that the effect of the referendum was to deny decent housing to low-income residents and that, "[i]f apart from voter motive, the result of this zoning by referendum is discriminatory in this fashion, . . . a substantial constitutional question is presented."[87] The court then went on to hold that if land use planning improved the quality of life for a city's residents in general, the poor could not be excluded from the enjoyment of those benefits. As a matter of law, it might well be "the responsibility of a city and its planning officials to see that the city's plan as initiated or as it develops accommodates the needs of its low-income families, who usually—if not always—are members of minority groups."[88] The impact of such a statement is that the equal protection clause was expressly applied to the poor as a class. It appears that the judge writing the opinion, upon realizing what he had said, decided to add the last phrase which ties the poor to minority groups, as if that made him feel more comfortable with the proposition he was advancing.

The United States Supreme Court has also seemed a bit unsure about taking the step toward recognizing economic segregation as within the ambit of the equal protection clause. The Court, however, noted probable jurisdiction to hear the case of *James v. Valtierra.*[89] The appellees in *Valtierra* challenged an article of the California Constitution which provided that no low-rent housing project could be developed, constructed, or acquired by any state public body without the approval of a majority of those voting at a community election.[90] The primary contention of the appellees was that this provision violated the equal protection clause because it required those persons seeking low-rent public housing to be subject to a referendum, while other groups seeking any other type of housing were not required to submit to such a procedure. Based on this argument, a three-judge district court enjoined the enforcement of the referendum.[91] The Supreme Court reversed the district court since the referendum provision was not based on race and required approval for every low-rent housing project.[92] Thus, the Court seemed to be saying that wealth is not a suspect classification.

There were three vigorous dissents in *Valtierra.* Justices Marshall, Brennan, and Blackmun maintained that the referen-

[87]*Id.* at 295. An examination of this quote reveals that the court either did not realize what it was saying or inadvertently conceded that the zoning process under dispute was "zoning by referendum." *Id.*

[88]*Id.* at 296.

[89]402 U.S. 137 (1971).

[90]CALIF. CONST. art. XXXIV, § 1.

[91]313 F. Supp. 1 (N.D. Cal. 1970) (three-judge court).

[92]402 U.S. at 142-43.

dum provision "is an explicit classification on the basis of poverty—a suspect classification which demands exacting judicial scrutiny."[93] They further asserted that the fourteenth amendment not only prohibits racial discrimination, but also prohibits "singling out the poor to bear a burden not placed on any other class of citizen."[94] Whether or not *Valtierra* will put an end to the trend toward protecting the poor's interests remains to be seen.[95] For those seeking to weaken exclusionary barriers, *Valtierra* need not be construed so broadly as to prevent the utilization of the equal protection clause in attacking local zoning ordinances. First, *Valtierra* was not a zoning case. Rather, it can be viewed as a case dealing with the validity of a referendum. A close reading of the majority opinion reveals that much of the decision is based on upholding a referendum as a matter of democratic decision-making. Thus, if a direct attack were made on a zoning law designed to exclude the poor, the Court's decision might be otherwise, especially in light of the dissenters' viewpoint. Second, the Supreme Court has afforded remedies to the poor when there has been an unjustified discrimination between the rich and the poor. Some examples include an indigent's right to free counsel,[96] proscription of the poll tax,[97] and an indigent's right to a free transcript.[98] Third, there have been some zoning cases since *Valtierra* signaling that zoning ordinances that have the effect of excluding the poor are violative of the equal protection clause.

A recent case dealing explicitly with the exclusion of the poor is *Southern Burlington County NAACP v. Township of Mount Laurel.*[99] Since the case was decided subsequent to *Valtierra,* it takes on an added importance. In *Mount Laurel,* the defendant township preferred only homes for persons with high incomes. The township consistently prohibited trailer or mobile homes, and multi-family uses had been restricted by ordinance as early as 1954.[100] When variances were requested to build apartments, they were granted only for high-rent structures. There was evidence that revealed that the attitude of the local zoning authority showed no concern for the welfare of its low-income resi-

[93]*Id.* at 145.

[94]*Id.*

[95]*See generally* Note, *The Equal Protection Clause and Exclusionary Zoning After* Valtierra *and* Danderidge, 81 YALE L.J. 61 (1971); Note, *Exclusionary Zoning and Equal Protection,* 84 HARV. L. REV. 1645 (1971).

[96]Douglass v. California, 372 U.S. 353 (1963).

[97]Harper v. Virginia Bd. of Elections, 383 U.S. 663 (1966).

[98]Griffin v. Illinois, 351 U.S. 12 (1956).

[99]119 N.J. Super. 164, 290 A.2d 465 (1972), *aff'd,* 67 N.J. 151 (1975).

[100]119 N.J. Super. at 168, 290 A.2d at 467.

dents.[101] Finally, it was dramatically illustrated that the township would do nothing for those living in substandard conditions. For example, the township refused to condemn deplorable structures in order to escape the required relocation of the affected families.[102] The condition of those structures decayed to the point where human existence within them became impossible.[103] When the families moved out, the township would move in and tear the buildings down. Thus, Mount Laurel Township not only prohibited low-income, multi-family uses by ordinance, but also utilized measures to drive out their low-income residents.

The plaintiffs were residents who lived in blighted areas of Mount Laurel and who had attempted to find livable quarters elsewhere within the township. Their attempts had proved futile, since there was no low-income housing in Mount Laurel. Many were forced to move to adjoining municipalities to find shelter. In the face of this situation, sixty-six percent of Mount Laurel Township was vacant land. The plaintiffs contended that the zoning ordinance prohibiting multi-family structures was designed to foster economic segregation, thus denying them equal protection of the laws. The New Jersey court agreed.

In reaching its decision, the court immediately dispensed with the *Valtierra* case by asserting that its majority opinion should be given little weight because low-income housing was not singled out for mandatory referendums under the California law. The court then restated the reasoning of the dissenting opinion in *Valtierra* as the basis of its holding.[104] Dicta from *Southern Alameda Spanish Speaking Organization*, and even some language from *Euclid* that warned of the effects of legislative zoning, were also relied upon.[105] Although the court accepted the general principle against judicial scrutiny of the exercise of police powers by a legislative body, the court nevertheless recognized its duty

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[101]For example, in a 1968 discussion with the mayor, a township committeeman stated that "it was the intent of the township to clear out substandard housing in the area and thereby get better citizens." *Id.* at 169, 290 A.2d at 468. In a 1969 township committee meeting, a variance for multi-family dwelling units was rejected because the committee did not see a need for such construction. In 1970, under pressure from federal and state government to encourage low-cost housing, a meeting was held at which a committeeman stated that approval should be given only to those development plans which provide direct and substantial benefits to the township's taxpayers. *Id.*

[102]*Id.* at 171, 290 A.2d at 469.

[103]Therefore, by necessity, some of the plaintiffs were living in vermin-infested structures where drains did not work, cesspools backed up into toilets, no indoor hot and cold running water plumbing was available, and ceilings were collapsing. *Id.* at 167, 290 A.2d at 467.

[104]*Id.* at 171, 290 A.2d at 469.

[105]See note 43 *supra*.

to scrutinize the issue of discrimination. "The Courts, however, must be ever watchful of any discriminatory acts of local units of government against the rights and privileges of the poor and underprivileged."[106] In ultimately holding the ordinance void as violative of the equal protection clause, the court concluded that it is "improper to build a wall against the poor income people."[107] The court found that the zoning patterns and practices of the defendant municipality clearly exhibited economic discriminations. The poor had been deprived of adequate housing and the opportunity to obtain such by subsidies. Federal, state, county, or local finances had been used solely for the betterment of middle-income and upper-income persons.

With *Mount Laurel* the judiciary finally took the last step toward recognizing that suburban governments could not use exclusionary zoning tactics to exclude the poor as a class without violating the equal protection clause of the fourteenth amendment. Even more significant, "[t]his is probably the only decision to date wherein a zoning ordinance has been held invalid specifically on the basis that the ordinance discriminated against the poor."[108] Nevertheless, such a radical departure from traditional zoning law did not satisfy the court in finding a remedy for the complainants. The court ordered Mount Laurel Township to undertake a study to identify the housing needs for persons of low income and moderate income presently residing in the township and employed by the municipality, and the expected or projected number of low-income and moderate-income people that could reasonably be anticipated to be employed within the county. Upon completion of this investigation, the township was ordered to develop an affirmative action program to enable and encourage the satisfaction of the needs uncovered by the study.

### *D. A Recent Obstacle?*

Against this backdrop, the United States Supreme Court in 1974 reviewed the case of *Village of Belle Terre v. Boraas,*[109] the first zoning case it heard since 1928.[110] The village had an ordi-

[106]119 N.J. Super. at 175, 290 A.2d at 471.

[107]*Id.* at 176, 290 A.2d at 472.

[108]Elias, *supra* note 31, at 17-18.

[109]416 U.S. 1 (1974).

[110]See note 10 *supra.* Recently the United States Supreme Court imposed a serious threshold obstacle upon litigants seeking to challenge exclusionary zoning tactics. In Warth v. Seldin, 95 S. Ct. 2197 (1975), various groups of petitioners sought declaratory, injunctive, and monetary relief against the respondent town of Penfield, New York, and members of the town's zoning, planning and town boards. Petitioners alleged that Penfield's zoning ordinance, by its terms and as enforced, in violation of petitioner's constitutional rights,

nance which restricted land use to one-family dwellings and specifically excluded lodging houses, boarding houses, fraternity houses, and multiple-dwelling houses. The ordinance also required that no more than two persons unrelated by blood, adoption, or marriage could live together as a "family" in a one-family dwelling.[111] When the village discovered that six students from a nearby university, none related by blood, adoption, or marriage, were living in the same house, it sought an order to remedy this violation of the ordinance. The owners of the house and three of the tenants then brought an action to have the ordinance declared unconstitutional.[112] The main thrust of their argument was that the ordinance violated the equal protection clause because it established a classification between households of related and unrelated individuals. This, the students contended, violated their fundamental rights of travel, association, and privacy. Unless the village could show a compelling interest to justify its infringement of these rights, the ordinance must fail. Although the district court upheld the ordinance,[113] the Court of Appeals for the Second Circuit[114] found the ordinance unconstitutional and reversed the district court.

The Supreme Court of the United States reversed, holding the ordinance a valid exercise of local zoning power.[115] The basis for the reversal was a strong reaffirmation of the *Euclid* decision and the presumption of validity principle. The Court quickly dispensed with the equal protection argument by citing a few cases to illustrate that no suspect classification or fundamental right was present which could trigger strict scrutiny review.[116] The Court held that such economic and social legislation should be upheld against an equal protection challenge if the law is

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effectively excluded persons of low and moderate income from living in the town. The Court held that none of the petitioners met the threshold requirement of standing to prosecute the action. Although the question of standing is beyond the scope of this Note, the *Warth* decision is an important one to be considered by those seeking relief from exclusionary zoning practices.

[111] The ordinance defined a family as:

> One or more persons related by blood, adoption, or marriage, living and cooking together as a single housekeeping unit, exclusive of household servants. A number of persons but not exceeding two (2) living and cooking together as a single housekeeping unit though not related by blood, adoption, or marriage shall be deemed to constitute a family.

416 U.S. at 2.

[112] 367 F. Supp. 136 (E.D.N.Y. 1972).

[113] *Id.*

[114] 476 F.2d 806 (2d Cir. 1973).

[115] 416 U.S. 1 (1974).

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> It is not aimed at transients. Cf. *Shapiro v. Thompson*, 394 U.S. 618. It involves no procedural disparity inflicted on some but not on others

reasonable and bears a rational relationship to a permissible state purpose.[117] Then, using the *Euclid* rationale and a standard of low scrutiny review, the Court found that the classification between households that constitute a family, even if two unrelated persons reside within, and households of unrelated individuals, was a reasonable exercise of zoning power in promoting Belle Terre's objective of providing a "quiet place where yards are wide, people few, and motor vehicles restricted . . . in a land-use project addressed to family needs."[118]

It should be noted that in tossing aside the equal protection argument the Court explicitly pointed out that economic classification does not warrant high scrutiny review. Coupled with the *Valtierra* decision, this could portend the demise of the equal protection attack upon an exclusionary ordinance based on wealth, a tactic frequently used to exclude the poor and the minorities. It appears that the Supreme Court may have sanctioned a new form of exclusionary zoning. A municipality need only devise an ordinance which contains a restrictive definition of "family," because the *Belle Terre* Court took the position that it is a legitimate state objective to preserve the character of single-family districts.[119]

Notwithstanding the above interpretation, it is still questionable whether *Belle Terre* has injected new life into the ability of local zoning authorities to utilize exclusionary tactics. *Belle Terre* is distinguishable from most exclusionary cases. The factors present in other cases, which suggested that the *Euclid* principles should be refashioned to conform to modern exigencies, were either not present or not brought into issue in *Belle Terre*. Thus, the Court was not squarely presented with an opportunity to review those principles.

First, Belle Terre consisted of about 220 homes and 700 residents in a total land area of less than one square mile. Whether or not surrounding localities were overpopulated, composed of different racial or economic groups, or zoned in a less restrictive manner than Belle Terre could certainly have been critical in

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such as was presented by *Griffin v. Illinois*, 351 U.S. 12. It involves no "fundamental" right guaranteed by the Constitution, such as voting, *Harper v. Virginia Board*, 383 U.S. 663; the right of association, *NAACP v. Alabama*, 357 U.S. 449; the right of access to the courts, *NAACP v. Button*, 371 U.S. 415; or any rights of privacy, cf. *Griswold v. Connecticut*, 381 U.S. 479; *Eisenstadt v. Baird*, 405 U.S. 438, 453-54.

416 U.S. at 7-8.

[117]416 U.S. at 8.

[118]*Id.* at 9.

[119]*See* 5 CUMBER-SAM. L. REV. 309 (1974).

determining whether a due process argument, based upon the expanding notion of zoning for the regional general welfare, should have been included in the tenant's complaint and subsequently litigated. Any challenge of an exclusionary ordinance should at least take these factors into account. The suit in *Belle Terre* was not presented in this manner. The cases examined in this Note dictate no less.

Second, the *Belle Terre* case can be distinguished from an economically based exclusionary case since the focus of the equal protection dispute in *Belle Terre* did not center around an ordinance designed to discriminate against the poor, as was the instance in *Mount Laurel.* In *Belle Terre,* the issue was narrowly confined to whether the word "family," as defined by the ordinance, created a burdened class in violation of the equal protection clause. Consequently, the Court was never presented with the types of situations that gave rise to the equal protection arguments in *Southern Alameda Spanish Speaking Organization, Valtierra,* and *Mount Laurel.*

### *E. A Note on Perspective*

The cases selected for discussion in this section were used to illustrate an emerging awareness by the judiciary of the discriminatory and injurious effects of exclusionary zoning. They have shown that local zoning powers have been limited by expanding the concept of the general welfare, by greater protection for the poor, not only the racial minorities, under the equal protection clause, and by court-ordered inclusion of low-income housing. However, only a minority of courts have shown a willingness to limit zoning powers. On the whole, courts throughout the country continue to rule on zoning issues according to *Euclidean* principles, and the *Euclidean* concepts of zoning remain relatively sound. It is in the megalopolis between Boston and Washington, D.C., and the urban sprawl regions, such as Los Angeles, where the traditional zoning principles have led to exclusionary zoning and where the new theories are necessarily emerging.

## VIII. Alternative Approaches to the Problem of Exclusionary Zoning

There is really no need to await the evolution of a synthesis of case law before an end to exclusionary tactics is realized. Executive action, legislation relief, or administrative remedies might also be used.

A widely acclaimed form of legislative action was taken by the Massachusetts legislature in November of 1969.[120] It has been

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[120]Mass. Ann. Laws ch. 40 B, § 20 (1973).

called the anti-snob zoning law. In essence, it allows a developer of low-income and moderate-income housing, turned down by a town zoning board, to appeal to the State Housing Appeals Committee. If the committee finds the zoning denial unreasonable or not "consistent with local needs," the denial is reversed. Local needs are predetermined: low-income and moderate-income housing units must comprise at least ten percent of the total housing units within a community, or such housing must comprise at least 1.5 percent of the land area zoned for residential, commercial, or industrial use. If either of these two standards is met, the community has fulfilled its obligation to provide low-income housing. Similarly, under an Alabama statute,[121] total exclusion of any economic class from a municipality is not permissible. There may be different economic classes, but every class must have some residential district.

An administrative lever that might be used in opening the suburbs to low-income housing is the Department of Housing and Urban Development. For example, HUD could deny or suspend an urban renewal or water and sewer grant to any community with a zoning ordinance which prohibits federally assisted low-income housing projects.

Some states are considering superseding local authority by terminating their enabling acts if local jurisdictions continue exclusionary practices or excessive provincialism.[122]

## IX. Conclusion

Exclusionary zoning tactics can be viewed as contemporary efforts to discriminate covertly against certain classes of Americans. The term itself implies such a concept. Exclusionary zoning is the abuse of a legitimate function to achieve illegitimate and often illegal ends. Exactly what constitutes an illegal use of the local zoning power is the controversy that now rages in the courts. As the cases selected for this Note illustrate, the boundaries of illegal use are being redefined. Must a valid exercise of the police powers require regional perspectives as a means to determine the general welfare? In legislating a zoning ordinance, must the needs of the poor be consciously provided for? Presently, the direction of the law is quite uncertain, and definitive answers to these questions are far from available. Yet legal principles cannot be permitted to stagnate while the reason behind their very existence, the welfare of society, is rapidly changing. The judiciary has only begun to take cognizance of this fact. Neverthe-

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[121] Ala. Code tit. 37, § 775 (1958).

[122] Elias, *supra* note 31, at 6.

less, we must not rely solely on the courts to resolve these questions of public policy. New federal housing laws, federal and state statutes, and administrative pressures must also be established to avert the undesirable consequences of exclusionary zoning. The preliminary groundwork has been set within the past ten years. Perhaps the next decade will be more fruitful in fashioning laws that will curb the abuse of local power, meet the needs of our times, and remedy a presently deplorable situation.

HOWARD POLSKY

# The Legal History of Zoning for Aesthetic Purposes

*If eyes were made for seeing,*
*Then beauty is its own excuse for being.*[1]

Since the beginning of the twentieth century, unparalleled urban growth coupled with the age-old sanctity of real property have joined to create American cities of uncontrolled ugliness. Zoning is a legislative attempt to guide the development of the urban environment. "The power to zone arises from the police power—the power of government to protect citizens. The need to zone arises because humanity clustered in cities demands a form of protection which is of no importance to humanity dispersed."[2]

Zoning has been recognized as a valid exercise of the police power since 1926.[3] The power of a municipality to institute zoning ordinances[4] arises from legislative enactment of zoning enabling acts. A typical enabling statute might read as follows:

> Such regulations shall be made in accordance with a comprehensive plan and designed to lessen congestion in the streets; to secure safety from fire, panic and other dangers; to promote health and the general walfare . . . . Such regulations shall be made with reasonable consideration, among other things, to the character of the district and its peculiar suitability for particular uses, and with a view to conserving the value of buildings and encour-

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[1]From *The Rhodora,* by Ralph Waldo Emerson, *found in* The Complete Essays and Other Writings of Ralph Waldo Emerson (Brooks Atkinson ed. 1940).

[2]F. Bair & E. Bartley, The Text of a Model Zoning Ordinance, (2d ed. American Society of Planning Officials 1960).

[3]In Village of Euclid v. Ambler Realty Co., 272 U.S. 365 (1926), a general zoning ordinance created a residential district and excluded businesses of various types. The ordinance was held not to be in violation of the due process and equal protection clauses of the United States and Ohio Constitutions.

[4]The validity of zoning ordinances depends generally upon the reasonableness of the restrictions and a balancing of such factors as:

(1) Existing uses and zoning of nearby property;
(2) Destruction of property values;
(3) Relative gain to the public as compared to hardship to the individual property owner;
(4) Suitability of the property for the purposes zoned; and at times,
(5) Motivation behind the restriction, that is whether the restriction is founded primarily on aesthetic considerations.

Roth, *The Place of Aesthetics in Zoning,* 14 DePaul L. Rev. 104, 105 (1964).

aging the most appropriate use of land throughout such municipality.[5]

Most zoning enabling acts recognize the need to restrict the use of land for the "health, safety, morals or general welfare" of the community, but do not specifically mention aesthetics or beauty as a valid criterion for the imposition of regulation on the use of land.[6] Courts must rely upon the general welfare term in lieu of a more clear manifestation of legislative approval of zoning for aesthetic purposes. Unfortunately, many courts have been unwilling to accept the general welfare term as a justification for use of the police power as readily as they accept the health, safety, and morals justifications. The traditional view is that aesthetic considerations are not within the scope of the general welfare. Even recently, some courts have not allowed aesthetic restrictions based solely on the general welfare clause, in part because of the difficulty in defining what the general welfare is, and in part because of the fear that aesthetic considerations are too subjective. Offenses to the senses of hearing and smelling have long been recognized because of the ease with which sound and odors can be measured; however, such is not the case with things offensive to sight.

This Note will survey the case law as it relates to aesthetic zoning and thus to the urban environment. The cases are classified in four categories: (1) Cases holding that aesthetic considerations are an invalid basis for zoning ordinances, (2) cases holding that aesthetic considerations are a valid secondary basis for zoning ordinances, (3) cases holding that aesthetic considerations are a valid basis for historic preservation zoning ordinances, and (4) cases holding that aesthetic considerations are a valid basis for zoning ordinances.

In some instances a case will be cited in more than one of these categories. The first and the last classifications are mutually exclusive, but otherwise a decision may stand for more than one principle.

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[5]ADVISORY COMMITTEE ON ZONING, A STANDARD STATE ZONING ENABLING ACT § 3 (Department of Commerce 1926).

[6]*See, e.g.*, IND. CODE § 18-7-4-1 (1974), which provides in part:

> [I]t is the object of this legislation to encourage local units of government to cooperatively improve the health, safety, convenience, and the welfare of their citizens and to plan for the future development of their communities to the end that highway systems be more carefully planned; that new communities grow only with adequate street, utility, health, educational and recreational facilities; that the needs of agriculture, industry, and business be recognized in future growth; that residential areas provide healthy surroundings for family life; and that the growth of the community is commensurate with and promotive of the efficient and economical use of public funds.

## I. Aesthetic Considerations Improper

Early courts were not receptive to the idea of zoning for aesthetic purposes. In 1905, the New Jersey Court of Appeals, in *Passaic v. Patterson Bill Posting, Advertising, & Sign Painting Co.*[7] characterized aesthetic zoning as a luxury, referring to aesthetic considerations as matters of indulgence rather than as matters of necessity. The court felt that only necessity would justify the exercise of police power. This sentiment was echoed by the New York Court of Appeals four years later in a case in which the court held an ordinance invalid because the municipality failed to show that the ordinance was reasonably related to the protection of the public interest.[8] Thus, courts adhering to the traditional view of zoning narrowly construed the zoning enabling acts and refused to expand the already too-broad scope of the general welfare term to include aesthetic regulation.

Even today, most jurisdictions do not recognize the validity of zoning ordinances based solely on aesthetic considerations. The Supreme Court of Pennsylvania stated its opinion of the weight to be given aesthetics by saying:

> [N]either aesthetic reasons nor the conservation of property values or the stabilization of economic values in a township are, singly or combined, sufficient to promote the health or the morals or the safety or the general welfare of the township or its inhabitants . . . .[9]

In California, the requirement that a fence surrounding a junkyard be solid was held to be for aesthetic reasons only and thus not valid.[10] Further, in Kansas, mere aesthetic considerations were declared not to bear such a relationship to the public welfare as to sustain zoning restrictions and ordinances.[11]

In more recent cases, there is a recognition of the importance of aesthetics in zoning and possibly even a desire to uphold ordinances so created, but the doctrine of stare decisis is restraining many courts. In a 1968 New Jersey case, *Piscitelli v. Township Committee*,[12] the 1905 *Passaic* decision formed the basis for the de-

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[7]72 N.J.L. 285, 62 A. 267 (N.J. Ct. App. 1905). *See also* Varney & Green v. Williams, 155 Cal. 318, 100 P. 867 (1909); Willison v. Cooke, 54 Colo. 320, 130 P. 828 (1913); Chicago v. Gunning System, 214 Ill. 628, 73 N.E. 1035 (1905).

[8]Wineburg Adv. Co. v. Murphy, 195 N.Y. 126, 88 N.E. 17, 113 N.Y.S. 854 (1909). The ordinance was designed to regulate "sky signs" within the limits of the city. The court noted that the ordinance did not appear to be enacted in the interest of public health or safety and thus was unauthorized.

[9]Appeal of Medinger, 377 Pa. 217, 221, 104 A.2d 118, 122 (1954).

[10]People v. Dickenson, 171 Cal. App. 2d 872, 343 P.2d 809 (1959).

[11]Miller v. Kansas City, 358 S.W.2d 100 (Kan. Ct. App. 1962).

[12]103 N.J. Super. 589, 248 A.2d 274 (1968).

cision of the court to hold invalid an ordinance creating a board to review the aesthetic compatibility of proposed structures.[13] Justice Feller noted:

> There is no doubt, and the law is well settled, that aesthetic value plays an important role in modern-day zoning legislation. Nevertheless, in this State it has been held that zoning power may not be exercised for purely aesthetic considerations.[14]

A Connecticut court made reference to the difficulty in defining and applying the term "aesthetics" and commented that vague and unidentfied aesthetic considerations have been and are an insufficient basis upon which to invoke the police power.[15]

Thus, there is a reluctance by many courts to break from the decisions of the past and allow aesthetic considerations as the sole justification for zoning regulation. The courts should take cognizance of increased public awareness of the need for aesthetic control and be more willing to disregard ancient precedent where the public interest has shifted. Many courts have, however, gradually recognized the applicability of aesthetic zoning to a general welfare clause or have allowed aesthetics as a secondary justification in upholding an ordinance if a more traditional basis can be found. Cases in the following section will show courts straining to sustain an ordinance on grounds other than aesthetics.

## II. Aesthetics Proper as a Secondary Basis

### A. *Health and Safety*

The most common situations in which courts have conceded the importace of aesthetics in zoning are the ones in which some relationship to the health and safety of the public can be shown.

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[13]In *Piscitelli,* the City of Scotch Plains had adopted an ordinance establishing an architectural review board. The purpose of the board was to review applications for building permits and to deny the application if the proposed structure did not aesthetically conform to the surroundings. In effect, the ordinance placed aesthetic values first and by doing so was held to create an unjustifiable precondition to the issuance of the building permit.

In *Passaic,* a city ordinance required the placing of billboards at least ten feet from the street line. This also was held an unjustifiable restriction because it was not related to public health or safety. The court surmised that the regulation was aesthetically motivated and thus not reasonable.

It should be noted that the court in *Piscitelli* did recognize aesthetics as a legitimate secondary purpose for zoning, whereas the *Passaic* court completely discounted the value of aesthetic considerations.

[14]103 N.J. Super. at 597, 248 A.2d at 278.

[15]DeMaria v. Enfield Planning & Zoning Comm'n, 159 Conn. 534, 271 A.2d 105 (1970).

Many courts adopted this line of reasoning in sustaining the regulation of billboards,[16] the control of junkyards,[17] and the exclusion of businesses from residential areas.[18] What may be of more importance is the trend of many courts toward the recognition of aesthetics as a valid secondary justification for the enactment of zoning regulations. At the very least, most jurisdictions hold that the entry of aesthetic considerations into the legislative process will not invalidate an otherwise valid ordinance.[19] The courts have recognized the significance of aesthetic considerations in comprehensive zoning programs. What is of interest is the reasoning by which ultimate judicial approval of the ordinance is reached.

The imposition of setback lines is generally regarded as important to the aesthetic appeal of a neighborhod. But, this is not sufficient justification in most courts today to uphold the setback requirements found in many zoning ordinances; rather, such ordinances are rationalized on the basis of health and safety.[20] Similarly, minimum lot size regulations have been litigated and upheld on the basis of their relation to the public health and safety.[21] Some courts have also recognized the aesthetic value of minimum floor space requirements, although they have failed to decide the cases solely on that ground.[22] In *Lionshead Lake v. Wayne Township,*[23] the court talked in the familiar health and safety language, but also spoke of the aesthetic considerations taken into account when zoning ordinances are enacted.

> It requires as much official watchfulness to anticipate and prevent suburban blight as it does to eradicate city slums. . . . The size of the dwellings in any community inevitably affects the character of the community and

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[16]St. Louis Gunning Adv. Co. v. City of St. Louis, 235 Mo. 99, 137 S.W. 929 (1911).

[17]City of St. Louis v. Friedman, 358 Mo. 681, 216 S.W.2d 475 (1948); Farley v. Graney, 146 W. Va. 22, 119 S.E.2d 833 (1960).

[18]Turner v. City of New Bern, 187 N.C. 540, 122 S.E. 469 (1924).

[19]Welch v. Swasey, 214 U.S. 91 (1908); Kenyon Peck,. Inc. v. Kennedy, 210 Va. 60, 168 S.E.2d 117 (1969).

[20]Gorieb v. Fox, 274 U.S. 603 (1927) (setback lines not arbitrary but had some relation to health and safety).

[21]Thompson v. City of Carrollton, 211 S.W.2d 970 (Tex. Ct. App. 1948). The *Thompson* court stated that the ordinances were "designed to lessen congestion in the streets; to secure safety from fire, panic and other dangers." *Id.* at 971.

[22]Corning v. Town of Ontario, 204 Misc. 38, 121 N.Y.S.2d 288 (Sup. Ct. 1953); Flower Hill Bldg. Corp. v. Village of Flower Hill, 199 Misc. 344, 100 N.Y.S.2d 903 (Sup. Ct. 1950).

[23]10 N.J. 165, 89 A.2d 693 (1952).

> does much to determine whether or not it is a desirable place in which to live.[24]

Other situations in which zoning has been upheld ostensibly because of interest in protecting health and safety are numerous and widespread throughout the jurisdictions.[25] Many other cases specifically recognize aesthetics as a valid secondary condition although not as a valid primary motive.[26] However, in *Preferred Tires, Inc. v. Village of Hempstead,*[27] the court, while noting the danger of overhead signs to pedestrians and other travelers, made clear in dicta that aesthetic considerations alone would be sufficient.

> This court is not restricted to aesthetic reasons in deciding to sustain the validity of the ordinance in question, but if it were so restricted, it would not hesitate to sustain the legislation upon that ground alone. The court cannot believe that . . . a municipal board in this day and age can be so restricted, as plaintiff contends, in thus promoting the happiness and general welfare of the community.[28]

Unhappily, the New York court is in a somewhat singular position. Most jurisdictions, even in recent decisions, beg the aesthetic issue and validate their zoning ordinances through the more traditional channels of health and safety.[29] In *Thille v. Board of Public Works,*[30] a California case, and *Appeal of Kerr,*[31] a Penn-

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[24]*Id.* at 173, 89 A.2d at 697.

[25]City of Atlanta v. Awtry & Lowndes Co., 205 Ga. 296, 53 S.E.2d 358 (1949) (funeral home in residential area); Giangrosso v. City of New Orleans, 159 La. 1016, 106 So. 549 (1925) (businesses forbidden in residential district); Turner v. City of New Bern, 187 N.C. 540, 122 S.E. 469 (1924) (lumber yard in residential district); Farley v. Graney, 146 W. Va. 22, 119 S.E.2d 833 (1960) (screening of junkyard required).

[26]Neef v. City of Springfield, 380 Ill. 275, 43 N.E.2d 947 (1942); Town of Burlington v. Dunn, 318 Mass. 216, 61 N.E.2d 243 (1945); Town of Lexington v. Govenar, 295 Mass. 31, 3 N.E.2d 19 (1936); Carter v. Harper, 182 Wis. 148, 196 N.W. 451 (1923). *See generally* Burk v. Municipal Court, 229 Cal. App. 2d 696, 40 Cal. Rptr. 425 (1964); 122 Main Street Corp. v. City of Brockton, 323 Mass. 646, 84 N.E.2d 13 (1949); General Outdoor Adv. Co. v. Department of Pub. Works, 289 Mass. 149, 193 N.E. 799 (1935).

[27]19 N.Y.S.2d 374 (Sup. Ct. 1940). This case is a forerunner of the current New York position.

[28]*Id.* at 377.

[29]Central Adv. Co. v. City of Ann Arbor, 42 Mich. App. 59, 201 N.W.2d 365 (1972); Sun Oil Co. v. City of Madison Heights, 41 Mich. App. 47, 199 N.W.2d 525 (1972); Campbell v. Ughes, 7 Pa. Commw. 98, 298 A.2d 690 (1972); Kenyon Peck, Inc. v. Kennedy, 210 Va. 60, 168 S.E.2d 117 (1969); Weiss v. Guion, 17 F.2d 202 (6th Cir. 1926) (setback lines held to have a reasonable relation to health and safety).

[30]82 Cal. App. 187, 255 P. 294 (1927).

[31]294 Pa. 246, 144 A. 81 (1928).

sylvania case, the courts recognized the connection between aesthetics and the general welfare, but based their decisions on the public health and safety.[32] Both courts realized the potential strength of the general welfare term, but were reluctant to say that a setback ordinance was sustainable under that term alone. This rationale is unfortunate because the most probable reason for the enactment of the setback requirement was to guarantee the beauty of the neighborhood rather than to promote the safety of the community. Assurance of aesthetic niceties such as lawns and open space should be as important to the courts as to zoning boards and planning commissions and should thus be entitled to legal protection solely under a general welfare clause. However, upon a finding that health, safety or moral considerations could have justified the zoning ordinance, many courts will assume that they did and fail to discuss further the aesthetics issue.[33]

### *B. The General Welfare Term*

#### *1. Emerging Definitions*

Acceptance of the general welfare term of the various zoning enabling acts as a valid basis for the exercise of the police power has been a gradual process in the state courts. There continues to be reluctance to expansively interpret the term because of the variety of situations that could arguably fall within the ambit of the general welfare, but some jurisdictions have recognized the need for expansion, within reasonable limits, of the aesthetic and cultural side of municipal development.[34]

The process has been slow, and some courts have only recently expanded their concepts of the general welfare. In *Criterion Service v. City of East Cleveland*,[35] the argument that the prohibition of billboards in retail store districts was founded on purely aesthetic reasons was met by an extension of the general welfare idea.

> The right of a city to classify its territory into use zones, under a complete zoning ordinance, must be liberally construed not only as it may affect the public health, morals, and safety, but also as such classifications are deemed necessary in promoting the public convenience, comfort, prosperity and general welfare and in giving consideration

[32]"While a zoning ordinance cannot be sustained on merely aesthetic grounds, that may be considered in connnection with questions of general welfare." *Id.* at 250, 144 A. at 83.

[33]Giangrosso v. City of New Orleans, 159 La. 1016, 106 So. 549 (1925); Civello v. New Orleans, 154 La. 271, 97 So. 440 (1923).

[34]Ware v. City of Wichita, 113 Kan. 153, 214 P. 99 (1923) (this legislation was said to be a liberalized application of the general welfare term.)

[35]55 Ohio Law Abs. 90, 88 N.E.2d 300 (Ohio Ct. App. 1949).

to these questions the council may be motivated in part at least by esthetic considerations.[36]

In the development of zoning for aesthetic purposes there have been two areas in which the courts have been more receptive to aesthetic considerations: preservation of the neighborhood and protection of property values. It may be that these concepts provide more concrete definition of general welfare and thus have enabled the courts to more readily interpret that term. Regardless of the reasons, many ordinances have been upheld by reference to the need to protect the character and value of land rather than by reliance on traditional health and safety requirements. This liberalization and definition of the general welfare term is an important step in zoning for aesthetic reasons.

### 2. *Preservation of Area Character*

In *Elbert v. North Hills*,[37] aesthetic considerations were approved in conjunction with health, safety, and the desire to maintain the quietude and rural character of a community as a proper motivation for local regulation. An Illinois court also recognized that a court may take into consideration the character of the neighborhood.[38] Preservation of the character of the community has been held the basis for the regulation of minimum lot areas,[39] even to the point of upholding a five-acre minimum in New Jersey.[40] Validity of an ordinance is still subject to attack on reasonableness grounds,[41] but the burden is upon the plaintiff to show that the action of the legislative body or commission entrusted with zoning decisions was arbitrary or unreasonable.

Recently, courts in many jurisdictions have approved ordinances predicated upon the protection of the character of a community. Florida courts assented to the protection of a single-family residential district along a lake and an ocean[42] and have also in-

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[36]*Id.* at 95, 88 N.E.2d at 303. *See also* City of Daytona Beach v. Abdo, 112 So. 2d 398 (Fla. Ct. App. 1959); McGuire v. Purcell, 7 Ill. App. 2d 407, 129 N.E.2d 598 (1955); United Adv. Corp. v. Borough of Metuchen, 42 N.J. 1, 198 A.2d 447 (1964).

[37]28 N.Y.S.2d 317 (1941). *See* Fox Meadow Estates, Inc. v. Culley, 233 App. Div. 250, 252 N.Y.S. 178 (1931).

[38]Trust Co. of Chicago v. City of Chicago, 408 Ill. 91, 96 N.E.2d 499 (1951). *See also* Kaplan v. City of Boston, 330 Mass. 381, 113 N.E.2d 856 (1953), wherein the primary purpose of zoning was said to be the preservation for the public good of residential neighborhoods against deleterious uses.

[39]Clary v. Borough of Eatontown, 41 N.J. Super. 47, 124 A.2d 54 (1956).

[40]Fischer v. Bedminster Twp., 11 N.J. 194, 93 A.2d 378 (1952).

[41]The test for reasonableness is outlined in note 4 *supra*.

[42]Watson v. Mayflower Property, Inc., 223 So. 2d 368 (Fla. Ct. App. 1969).

validated an ordinance because the appellant's land, given the characteristics of the surrounding area, was not suitable for single-family residences as zoned.[43] In Colorado, an ordinance which required large building lots in the center of a village, which had been incorporated with the express desire and purpose of maintaining a rural atmosphere, was held to be within statutory authority and not an unreasonable exercise of police power.[44] A New Jersey court, in recognizing the aesthetic importance of uniform community maintenance, stated that the physical characteristics of and the existing circumstances in the community must enter into the decision-making process when the validity of a zoning ordinance is challenged.[45]

It is clear that preservation of the character of a community has been accepted,[46] even though it is admittedly an exercise of aesthetic control over the physical appearance of specific areas. As a valid objective of the general welfare, character preservation has had a great influence in saving many residential areas from the unwanted infiltration of business and industry.

### 3. *Preservation of Property Value*

Companion to the preservation of area character has been the preservation of property value. It is widely recognized that the value of residential land will be adversely affected by the construction of factories, businesses, or other commercial establishments because of increased traffic, noise, and pollution. Further, the value of residential property may be affected by the destruction of parks, woods or other open spaces, and scenery. Urban zoning ordinances are often enacted with these considerations in mind, and the courts have shown a willingness to accept such regulation as within the scope of the general welfare.[47] A leading case in this area is *Saveland Park Holding Corp. v. Wieland*,[48] in which the Wisconsin Supreme Court sustained an ordinance controlling the architectural appeal of a building. The ordinance provided that a building permit could be issued only

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[43]William Murray Builders, Inc. v. City of Jacksonville, 254 So. 2d 364 (Fla. Ct. App. 1971) (thirty-five acre plot zoned residential when surrounded by marshland, railroad yard, sewage disposal plant, gas station, and large apartment complex.)

[44]Nopro Co. v. Town of Cherry Hills Village, 504 P.2d 344 (Colo. 1972).

[45]J.D. Construction Corp. v. Township of Freehold, 119 N.J. Super. 140, 290 A.2d 452 (1972).

[46]Lindgren v. City of Chicago, 124 Ill. App. 2d 289, 260 N.E.2d 271 (1970).

[47]Conner v. City of University Park, 142 S.W.2d 706 (Tex. Ct. App. 1940).

[48]269 Wis. 262, 69 N.W.2d 217 (1955).

after the Fox Point Building Board had found the exterior architectural appeal of the proposed structure to be compatible with the existing and proposed buildings in the neighborhood so as not to cause a substantial depreciation in property values. The trial court held the ordinance unconstitutional on three grounds. In reversing the court below, the Supreme Court of Wisconsin decided that (1) the protection of property values is an objective which falls within the general welfare clause, (2) the general rule prohibiting the exercise of the zoning power for aesthetic reasons only is undergoing development, and it is extremely doubtful that the prior rule is still the law, and (3) the words "substantial" and "neighborhood" were not so vague as to render the ordinance void.

In its discussion of property values as a valid legislative objective for zoning, the court said:

> [T]he protection of property values is an objective which falls within the exercise of the police power. . . . Anything that tends to destroy property values of the inhabitants of the village necessarily adversely affects the prosperity, and therefore the general welfare, of the entire village . . .[49]

In 1964, the New Jersey Supreme Court astutely noted the close relationship between property values and aesthetic considerations by stating:

> There are areas in which aesthetics and economics coalesce, areas in which a discordant sight is as hard an economic fact as an annoying odor or sound. We refer not to some sensitive or exquisite preference but to concepts of congruity held so widely that they are inseparable from the enjoyment and hence the value of property.[50]

Further, the court criticized the practice of attaching zoning established for aesthetic reasons to the health or safety:

> Surely no one would say today that an industrial structure must be permitted in a residential district upon a showing that the operation to be conducted therein involves no significant congestion in the streets, or danger of fire or panic, or impediment of light and air, or overcrowding of land, or undue concentration of population.[51]

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[49]*Id.* at 270, 69 N.W.2d at 222.

[50]United Adv. Corp. v. Borough of Metuchen, 42 N.J. 1, 5, 198 A.2d 447, 449 (1964).

[51]*Id. See also* Township of Livingston v. Marcher, 85 N.J. Super. 428, 205 A.2d 65 (1964), wherein the integral relationship between neighborhood aesthetics and property values was recognized.

The point was made that aesthetics should not be ignored and are as much a part of the general welfare as health, safety, or morals. The connection between aesthetic impact and economic effect is an integral part of the general welfare.

A sampling of cases reveals approval of ordinances to protect the economic value of existing uses,[52] to prevent untidy appearance of land and diminution of land value,[53] to promote tourism,[54] and to halt the deterioration of an area and the resulting depreciation of property value.[55]

Of course, any combination of preservation of character and protection of property values may be employed by a court. In *Reid v. Architectural Board of Review*,[56] the ordinance approved established an architectural board of review and instructed the members of the board to regulate the orientations of all new buildings according to proper architectural principles. The purpose of the regulation was to protect the value of real property and to assure a high character of community development. Although this type of regulation is susceptible to arbitrary action on the part of the board members, the necessity for architectural standards justified the delegation of authority to the board.

In cases involving property values, plaintiffs often argue that refusal to allow them to use the land at its highest and best use amounts to a taking of property without due process. However, courts have held that a mere reduction in the value of property affected will not be sufficient to invalidate the ordinance on due process grounds.[57] Plaintiffs often contend in the alternative that the property affected should be rezoned to allow their desired use. Generally such rezoning also will be refused when the sole purpose for the attempted rezoning is to put the property to its most remunerative use.[58] "[T]here is simply no constitutionally protected right . . . to gain the maximum profit from the use of

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[52]County of Brevard v. Woodham, 223 So. 2d 344, (Fla. Ct. App. 1969); City of Miami Beach v. Ocean & Inland Co., 147 Fla. 480, 3 So. 2d 364 (1941); Blades v. City of Raleigh, 280 N.C. 531, 187 S.E.2d 35 (1972).

[53]Melton v. City of San Pablo, 252 Cal. App. 2d 794, 61 Cal. Rptr. 29 (1967).

[54]Desert Outdoor Adv. v. County of San Bernardino, 255 Cal. App. 2d 765, 63 Cal. Rptr. 543 (1967); County of Santa Barbara v. Purcell, Inc., 251 Cal. App. 2d 169, 59 Cal. Rptr. 345 (1967).

[55]City of Kansas City v. Kindle, 446 S.W.2d 807 (Mo. 1969). *But see* Appeal of Manns, 3 Pa. Commw. 242, 281 A.2d 355 (1971).

[56]119 Ohio App. 67, 192 N.E.2d 74 (1963).

[57]Cosmopolitan Nat'l Bank v. City of Chicago, 1 Ill. App. 3d 478, 275 N.E.2d 310 (1971).

[58]Fields v. City of Little Rock, 475 S.W.2d 509 (Ark. 1972).

property."[59] It must be remembered, however, that an ordinance which would render a specific property valueless will probably be held improper on due process grounds.[60] Thus, a statute which will result in some loss in value is not necessarily invalid. However, substantial impairment of the value casts serious doubt upon the constitutionality of the ordinance as applied.

At this point, it is important to note briefly another role that property value may play in aesthetic zoning. It has been suggested that the area of aesthetic zoning is too subjective and that sight cannot be protected as efficiently from offense as the senses of hearing and smelling because of the ease with which sound and smell can be measured. Property value itself may be the best way to attach an objective measure to visual excellence. The value of aesthetics can be seen daily in the real property market. Lots with views often sell for substantially more than similar lots without views and are often assessed for the purpose of taxation at a higher rate. The prices of land located on permanent open spaces, golf courses, beaches, or parks are always higher than the prices of lots with less scenic surroundings. Buildings and lots with landscaping and trees are worth more to a purchaser because of the aesthetic pleasure they impart. Thus, aesthetic considerations do have a measurable value. Dollars can act as much as an objective measure of injury as decible levels or air samples.

The destruction of aesthetic amenities results in the lessening of the value of property[61] just as a malodorous factory or a noisy airport reduces land value. If the beauty of the land and thus its value can be protected via zoning for aesthetic purposes, then zoning enabling statutes should be interpreted so that such ends may be met.

## III. Aesthetics Proper in Historic Preservation

The preservation and protection of historic sites as an area of aesthetic zoning is a hybrid of zoning to preserve the character and value of property and zoning for aesthetic purposes only. The regulations are often imposed collaterally to protect the property value and the character of the area as well as to promote tourism. Many historic zoning regulations are intended to direct the architectural design of future buildings and to preserve that of existing buildings. These legislative ordinances are generally upheld. Protection by the city of New Orleans of the Vieux Carre district

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[59] Nopro Co. v. Town of Cherry Hills Village, 504 P.2d 344, 350 (Colo. 1972).

[60] Ziman v. Village of Glencoe, 1 Ill. App. 3d 912, 275 N.E.2d 168 (1971).

[61] People v. Ricciardi, 23 Cal. 2d 390, 144 P.2d 799 (1943); Frankland v. City of Lake Oswego, 493 P.2d 163 (Ore. Ct. App. 1972).

is a prime example of historic site preservation. Prohibition of changes in the exterior of a building in the historic district,[62] as well as the proscription of signs without the approval of the Vieux Carre Commission,[63] were held to be valid in light of the avowed purpose of saving the district for its aesthetic value and historic interest.

Massachusetts has enacted laws providing for the preservation of the architecture of Nantucket Island. Historically a famous whaling and fishing center, the area in recent years has been endangered by those vacationing in the resort. The use of the police power to protect the island was approved in *Opinion of the Justices to the Senate.*[64] The protection of the natural scenery and the historic buildings was the recognized focus of the regulation which included the requirement that a permit be issued before any building was altered. The Supreme Judicial Court of Massachusetts realized that "the proposed act can hardly be said in any ordinary sense to relate to the public safety, health, or morals."[65] But, in the interest of the appearance of the island, the ordinance was approved.

More recently, in *Rebman v. City of Springfield,*[66] it was held to be within the concept of the public welfare to effect the preservation of historical sites, so long as reasonable limitations were imposed. The limitations mentioned in *Rebman* are more fully outlined in *Hayes v. Smith*[67] where a brick addition to an historically protected clapboard church was allowed as generally compatible. The Rhode Island court reasoned that the legislature did not intend to require absolute duplication of existing style since such a requirement might jeopardize the validity of the historic zoning ordinance. Historic zoning, then, as all zoning, must meet a test of resonableness in light of the specific purposes which the zoning is intended to further.[68]

There are some problems peculiar to historic zoning. When a landowner is prevented from destroying an existing structure, he may abandon or allow the building to fall into such disrepair that it ultimately must be condemned. The prevention of deterioration of historic areas is often difficult, and the solution will vary in

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[62]City of New Orleans v. Impastato, 198 La. 206, 3 So. 2d 559 (1941).

[63]City of New Orleans v. Pergament, 198 La. 852, 5 So. 2d 129 (1941). *See* City of New Orleans v. Levy, 223 La. 14, 64 So. 2d 798 (1953).

[64]333 Mass. 773, 128 N.E.2d 557 (1955). *See also* Opinion of the Justices to the Senate, 333 Mass. 783, 128 N.E.2d 563 (1955) (protection of the historic Beacon Hill District in Boston).

[65]333 Mass. at 778, 128 N.E.2d at 561.

[66]111 Ill. App. 2d 430, 250 N.E.2d 282 (1969).

[67]92 R.I. 173, 167 A.2d 546 (1961).

[68]For a typical statute see IND. CODE § 18-4-22-1 (Burns 1974).

any given case. A court order compelling repair may be effective when the owner has the necessary financial resources. Some areas have set up local agencies empowered to make repairs upon the designated land and to record the cost of such repair as a lien upon the property. The ideal solution is to secure a buyer for the land who is willing to accept the maintenance expenses of his purchase.

Historic zoning resembles zoning for only aesthetic purposes and is often recognized for what it is—an attempt to preserve what is beautiful and historic so others may enjoy it. Today's society has become aware of the need to preserve parts of its heritage for the betterment and education of society in the future. Some states, most notably New York, Oregon, and Florida, have recognized that this reasoning can be applied to areas not so historically important, but just as aethetically pleasing and therefore valuable.

## IV. Aesthetics Proper as Sole Basis

In the history of zoning for aesthetic purposes, there are some early cases that are recognized as boldly ahead of their time. These cases established the basis for the modern trend, and the courts exhibited foresight in their understanding of the problems of urban deterioration and shabbiness.[69] However, the decision universally considered as setting the stage for acceptance of aesthetic considerations as wholly valid criteria in zoning is *Berman v. Parker*,[70] a 1954 United States Supreme Court decision. The District of Columbia had condemned Berman's property to make way for a privately controlled redevelopment project. The Court sustained the taking of land for what Berman contended was not a public use and countered his argument by stating that once the public interest had been established, the means of achieving that end were of little relevance.[71] Thus, the Court expanded the scope of condemnation proceedings by substituting the public purpose language contained in the police power for the public use language of eminent domain. In commenting on the significance of aesthetic considerations, Justice Douglas, writing the opinion of the Court, said:

> The concept of the public welfare is broad and inclusive. . . . The values it represents are spiritual as well as physical, aesthetic as well as monetary. It is within the power of the legislature to determine that the community should

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[69]Civello v. City of New Orleans, 154 La. 271, 97 So. 440 (1923).

[70]348 U.S. 26 (1954).

[71]This is sometimes referred to as the beneficial use theory.

> be beautiful as well as healthy, spacious as well as clean, well-balanced as well as carefully patrolled.[72]

In answer to questions of constitutionality, Justice Douglas further commented that "if those who govern the District of Columbia decide that the Nation's Capitol should be beautiful as well as sanitary, there is nothing in the Fifth Amendment that stands in the way."[73]

The use of eminent domain to impose aesthetic regulations has been widely accepted as a result of the *Berman* case. The difficulty arises when the use of zoning is contemplated to achieve the same result. The general rationale of *Berman* has been accepted by some state courts[74] and has been applied to zoning situations.[75] Thus, *Berman* has become a precedent in the use of both eminent domain and zoning. The power to condemn land for aesthetic purposes is extremely important in acquiring and preserving unimproved open spaces and smaller sites for the public benefit. The use of zoning to accomplish these ends will result in great financial savings to states and municipalities and is a welcome consequence of the *Berman* decision.

The New York courts are among the strongest supporters of aesthetic values. The New York Court of Appeals, in *People v. Stover*,[76] upheld a zoning ordinance prohibiting clotheslines in front and side yards abutting a street. The ordinance was based solely on aesthetic considerations. Recognizing that aesthetic considerations are accepted as a valid subject for legislative concern, the court held that any reasonable legislation instituted to promote the aesthetic nature of the community would be a valid exercise of the police power. Judge Fuld noted that the regulation imposed no arbitrary or capricious standard of beauty upon the community, but merely proscribed conduct which was offensive to the average person's visual sensibilities. It is interesting to note that the court could have decided the case on safety or property value grounds, but declined to do so.

The New York position has been reiterated in recent years[77] and, regardless of past decisions to the contrary, there is no doubt that at the present time aesthetic considerations alone are a proper basis for zoning ordinances in New York,[78] so long as the legisla-

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[72]348 U.S. at 33.

[73]*Id.*

[74]Davis v. City of Lubbock, 326 S.W.2d 699 (Tex. 1959).

[75]Saveland Park Holding Corp. v. Wieland, 269 Wis. 262, 69 N.W.2d 217 (1955).

[76]12 N.Y.2d 462, 191 N.E.2d 272, 240 N.Y.S.2d 734 (1963).

[77]Cromwell v. Ferrier, 24 App. Div. 2d 998, 225 N.E.2d 749, 266 N.Y.S.2d 188 (1962).

[78]People v. Berlin, 62 Misc. 2d 272, 307 N.Y.S.2d 96 (Dist. Ct. 1970).

tion is reasonably designed to promote and preserve the appearance of a community.[79] It is possible that this position has developed as a result of the long history of urbanization in that state and the effect such development has had in reducing the natural beauty of the area. However, regardless of the reasons, New York leads in what will surely be the trend in zoning regulation.

Florida has also effectively recognized the value of aesthetic considerations in zoning. The beauty of the state coupled with the strong tourist industry present key factors in the courts' decisions to uphold aesthetic zoning. *E. B. Elliot Advertising Co. v. Dade County,*[80] referred to *Stover* with approval and stated that aesthetic considerations are valid in promoting the general welfare. In another decision,[81] the Florida Court of Appeals acknowledged that the police power should not be confined narrowly to the public health, safety, or morality, but may be expanded to regulate occupations or businesses detrimental to the general welfare. A federal district court recently noted that the Florida courts had approved the enhancement of aesthetic appeal as a proper exercise of the police power, and added its approval.[82] The urgent need to protect the quality of the environment was mentioned as a national goal, thus further accentuating the importance of aesthetic considerations.

Oregon has also joined in approving aesthetic considerations alone as a valid basis for the exercise of the police power. In *Oregon City v. Hartke,*[83] the ordinance in question totally excluded a junkyard from the specified area. In this respect, the regulation was much more strict than the regulation in *Stover,* as the use in *Stover* was not wholly prohibited. The Oregon court realized the importance of urban planning and its relation to the well-being of city dwellers by saying that it is "not irrational for those who must live in a community from day to day to plan their physical surroundings in such a way that unsightliness is minimized."[84]

## V. CONCLUSION

Jurisdictions that accept aesthetic considerations as the sole justification for zoning ordinances are clearly in the minority today. The reluctance of the courts to infringe upon private

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[79]People v. Goodman, 31 N.Y.2d 262, 290 N.E.2d 139, 338 N.Y.S.2d 97 (1972).

[80]425 F.2d 1141 (5th Cir. 1970).

[81]Rotenberg v. City of Fort Pierce, 202 So. 2d 782 (Fla. Ct. App. 1967).

[82]Stone v. City of Maitland, 446 F.2d 83 (5th Cir. 1971). *See also* Sunad, Inc. v. City of Sarasota, 122 So. 2d 611 (Fla. 1960).

[83]240 Ore. 35, 400 P.2d 255 (1965).

[84]*Id.* at 50, 400 P.2d at 263.

citizens' property rights is in large part responsible for the slow acceptance of aesthetics as a valid excuse for regulation.

> The whole concept of zoning implies a restriction upon the owner's right to use a specific tract for a use profitable to him but detrimental to the value of other properties in the area, thus promoting the most appropriate use of land throughout the municipality, considered as a whole.[85]

It is a balancing of the public and private interests[86] that is difficult to apply and is of concern to judges and lawyers. However, this balancing process has and will continue to have central importance in aesthetic zoning issues.

There has been a continuing development of aesthetic principles by the courts and a gradual recognition of the importance of aesthetics in zoning. Clearly, many courts have been giving increased weight to aesthetic values. The reluctance of many courts to break away from traditional justifications for the use of the police power has been cited as a detriment to the development of a full recognition of aesthetics. The attorney should familiarize himself with the aesthetic zoning issues in the interest of a better environment.[87] The recent shift of public awareness to environmental problems should be reflected by the courts. The use of the police power to aesthetically improve our urban areas can be a valuable asset for the environmentalist, city planner, and resident alike.

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[85]Blades v. City of Raleigh, 280 N.C. 531, 546, 187 S.E.2d 35, 43 (1973).

[86]Chusud Realty Corp. v. Village of Kensington, 40 Misc. 2d 259, 243 N.Y.S.2d 149 (Sup. Ct. 1963).

[87]The lawyer seeking affirmation of aesthetic zoning has at least four arguments available: (1) that the majority of case holdings are in error; (2) that there exists a rational relationship between property value, other economic considerations, the character of the neighborhood, and the general welfare; (3) that the zoning is related to public health, safety, or morality, and (4) if appropriate, that there is need for historic preservation.

# Redlining: Potential Civil Rights and Sherman Act Violations Raised by Lending Policies

## I. Introduction

Redlining is the policy of lending institutions either to exclude certain geographic areas from consideration for home mortgages and rehabilitation loans or to vary the terms and conditions of such loans.[1] This policy can be implemented by various methods[2] and may be a violation of the loan applicant's civil rights if the affected neighborhoods are inhabited primarily by minority group members.[3] Redlining may also be a violation of

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[1]U.S. COMM'N ON CIVIL RIGHTS, UNDERSTANDING FAIR HOUSING (1973). In this brochure, redlining is defined as "the refusal to make any loan in a particular area." *Id.* at 14. *See also* U.S. COMM'N ON CIVIL RIGHTS, FEDERAL CIVIL RIGHTS ENFORCEMENT EFFORT—A REASSESSMENT (1973). The report states: " 'Redlining' is generally defined as a lending policy which excludes certain areas or neighborhoods from consideration in the making of mortgage or home rehabilitation loans." *Id.* at 168 n.13.

The Commissioner of the Illinois Savings and Loan Association on January 1, 1974, amended Article II of his Association's regulations pursuant to the Illinois Savings and Loan Act. ILL. ANN. STAT. ch. 32, §§ 805, 841.2 (1970). Section 9 of the regulations contains the following definition:

> "Redlining" is the practice of arbitrary varying the terms or application procedures or refusing to grant a mortgage loan within a specific geographical area on the grounds that the specific parcel of real estate proposed as collateral for the loan is located within said specific geographical area.

[2]The Housing Training and Information Center, 4207 West Division Street, Chicago, Illinois, 60651, has released a list containing eleven methods of redlining by financial institutions, which include requiring higher down payments than are usually required for financing comparable property, fixing higher interest rates or closing costs, fixing earlier maturity dates, fixing minimum dollar amounts for loans and thereby excluding lower priced properties, stalling on appraisals, setting appraisals below actual market value, applying more rigid appraisal standards, refusing to lend on the basis of "presumed economic obsolescence" no matter what the condition of the older property may be, and charging discount points to discourage financing.

[3]Relevant data suggests that redlining policies most often affect central city, minority group neighborhoods. For example, the Federal Home Loan Bank Board (FHLBB) in March, 1972, released a small sampling of member savings and loan associations with 74 respondents out of 100 surveyed. The responses to the sampling showed that thirty percent of the respondents disqualified some neighborhoods from lending because they were inhabited primarily by low-income or minority group members, and thirty-five answered "yes" to an inquiry as to whether or not redlining is a problem in the savings and loan industry.

On April 25, 1972, the United States Department of Housing and Urban Development (HUD) released a preliminary report of a survey made in co-

section 1 of the Sherman Act.[4] In this Note, the discussion will focus upon (1) violations of relevant civil rights laws by financial institutions pursuing a policy of redlining,[5] (2) violations of section 1 of the Sherman Act as a result of redlining, (3) prob-

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operation with all the federal financial regulatory agencies. Of the 582 savings and loan associations—from the 50 cities with the largest minority population—responding, seventeen percent stated that the racial or ethnic characteristics of the neighborhoods were considered in evaluating loan applications, and twenty percent stated that income levels of neighborhood residents were considered. Also, eighteen percent of the savings and loan associations responded that they refused to make loans in one or more areas with high concentrations of minority group members.

The National Committee Against Discrimination in Housing (NCDH), 1425 H Street, N.W., Washington, D.C., 20005, released a report in February, 1972, entitled "Patterns and Practices of Discrimination in Lending in Oakland, California." Documenting the lending record of three major savings and loan associations in the Oakland area, NCDH's study showed great differentials in the number of loans, depending upon the percent of blacks in given census tracts of the city.

The City of Indianapolis Department of Metropolitan Development in December, 1972, published "The Housing Component, A Staff Report for Community Review of the Unified Planning Program; 1970-1976 for the Indianapolis-Marion County Metropolitan Area." It is noted in the report that:

> Low-income households are not generally regarded as "good credit risks" when they attempt to take advantage of opportunities to get better quarters. In addition—*and often of even greater importance*—their residence in older close-in neighborhoods effectively shuts them off from access to standard credit channels, and if they can get financing at all, it is often at excessive rates and on burdensome terms. The long time "blacklisting" of neighborhoods by the Federal Housing Administration (FHA), now officially outlawed, meant an absolute curtailment of insured mortgage funds. Conventional financing institutions and insuring companies have followed the same practices.

*Id.* at 10-11 (emphasis added).

*See also* G. STERNLIEB & R. BURCHELL, RESIDENTIAL ABANDONMENT (1973). The authors observe that in Newark:

> Primary lenders in urban areas—commercial and mutual savings banks, savings and loan associations, insurance companies, and even individuals—are getting out of the inner city mortgage lending business.

*Id.* at 6. *See generally* M. STEGMAN, HOUSING INVESTMENT IN THE INNER CITY: THE DYNAMICS OF DECLINE (1972). Among many other related topics, the author discusses the unavailability of conventional financing for residents of Baltimore's inner city desiring home ownership.

[4]15 U.S.C. § 1 (1970).

[5]Two suits were filed last year charging defendants with racially discriminatory lending practices. Both complaints alleged that defendants—a savings and loan association in one case and a mortgage company in the other—engaged in acts and practices "which discriminate against property owners and potential home buyers because of the racial composition of the neighborhoods in which they live or intend to live." Complaint at 1, Harrison v. Heinzeroth Mortgage Co., No. C74390 (N.D. Ohio, filed Sept. 21, 1974).

lems in establishing the right to a legal remedy under both the civil rights laws and the Sherman Act, and (4) remedial approaches to redlining other than litigation.

## II. Redlining As a Violation of the Loan Applicant's Civil Rights

### A. *The 1968 Fair Housing Act*

The 1968 Fair Housing Act[6] (hereinafter referred to as Title VIII), through section 3605, proscribes the denial of a loan by any corporation, association, firm, or enterprise engaged in the business of making commercial real estate loans to any applicant because of the applicant's race, color, religion, or national origin.[7] A lending institution making residential mortgages and rehabilitation loans violates section 3605 if it pursues a policy of redlining minority group neighborhoods.[8] This is true even in the ab-

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The other suit is Laufman v. Oakley Bldg. & Loan Co., No. C174-153 (S.D. Ohio, filed Apr. 29, 1974).

[6]42 U.S.C. §§ 3601 *et seq.* (1970).

[7]*Id.* § 3605 provides:

*Discrimination in the Financing of Housing*

After December 31, 1968, it shall be unlawful for any bank, building and loan association, insurance company or other corporation, association, firm or enterprise whose business consists in whole or in part in the making of commercial real estate loans, to deny a loan or other financial assistance to a person applying therefor for the purpose of purchasing, constructing, improving, repairing, or maintaining a dwelling, or to discriminate against him in the fixing of the amount, interest rate, duration, or other terms or conditions of such loan or other financial assistance, because of the race, color, religion, or national origin of such person or of any person associated with him in connection with such loan or other financial assistance or the purposes of such loan or other financial assistance, or of the present or prospective owners, lessees, tenants, or occupants of the dwelling or dwellings in relation to which such loan or other financial assistance is to be made or given: *Provided,* That nothing contained in this section shall impair the scope or effectiveness of the exception in section 3603(b) of this title.

[8]Though shown to have violated section 3605, a lending institution may avoid liability if it establishes a business justification for redlining in minority group areas and shows that there was no less discriminatory way to accomplish its business goals. See note 84 *infra* & accompanying text.

Section 3604(a) of Title VIII, 42 U.S.C. § 3604(a) (1970), also appears to be violated by the redlining of minority group neighborhoods, which makes housing unavailable to potential borrowers. This section provides, in pertinent part, that it shall be unlawful "to refuse to sell or rent . . . *or otherwise make unavailable or deny* . . . a dwelling to any person because of race, color, religion, sex or national origin." *Id.* (emphasis added). Thus, section 3604(a) not only prohibits conduct constituting a refusal to sell or rent but also prohibits

sence of a showing that racial discrimination was intended, since practices that have a disparate racial impact constitute violations of Title VIII regardless of a party's intent.[9]

For example, in *United States v. Grooms*,[10] a federal district

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conduct that otherwise makes dwellings unavailable. The "otherwise make unavailable" language of the section has been given a broad reading by the courts. *See* United States v. City of Black Jack, 508 F.2d 1179 (8th Cir. 1974); United States v. City of Parma, 374 F. Supp. 730 (N.D. Ohio 1974); United States v. Youritan Constr. Co., 370 F. Supp. 643 (N.D. Cal. 1973); Zuch v. Hussey, 366 F. Supp. 553 (E.D. Mich. 1973). This language has also been applied to a variety of discriminatory conduct having nothing to do with a refusal to sell or rent. *See* United States v. City of Black Jack, United States v. City of Parma, and Zuch v. Hussey, *supra*.

In *Black Jack*, a zoning ordinance prohibiting the construction of any new multi-family dwellings was held to violate section 3604(a) when shown to have the effect of making housing unavailable to blacks because of race. Similarly, in *Zuch* any action or word by a real estate broker or salesman used to influence the choice of a prospective homebuyer on a racial basis was held to violate section 3604(a). Outlining the prohibitions of section 3604(a), the court in *Zuch* noted:

> [S]ection [3604(a)] makes it unlawful to "otherwise make unavailable" housing or to deny housing because of race. The foregoing phraseology appears to be as broad as Congress could have made it, and all practices which have the effect of making dwellings unavailable on the basis of race are therefore unlawful.

366 F. Supp. at 557.

The redlining of minority group areas, though not conduct involving a refusal to rent or sell, clearly is conduct which makes dwellings unavailable on the basis of race when a buyer is unable to purchase a dwelling because of his inability to obtain a mortgage loan. Therefore, the redlining of minority group areas which makes dwellings unavailable should be a violation of section 3604(a).

[9]United States v. West Peachtree Tenth Corp., 437 F.2d 221 (5th Cir. 1971); United States v. Grooms, 348 F. Supp. 1130 (M.D. Fla. 1972); United States v. Real Estate Dev. Corp., 347 F. Supp. 776 (N.D. Miss. 1972); Banks v. Perks, 341 F. Supp. 1175, 1179 (N.D. Ohio 1972).

*See also* "The Applicability of the Board's Nondiscrimination Regulation to the Practice of 'Redlining' by FHL Bank Member Institutions," Inter-Office Communication from Charles E. Allen, General Counsel of the Federal Home Loan Bank Board, to Richard Platt, Jr., Mar. 21, 1974, on file at the office of the *Indiana Law Review*. In this inter-office memo, Mr. Allen discusses the cases cited *supra* and states that "practices which are discriminatory in effect are unlawful . . . under Title VIII." *Id.* at 4. Mr. Allen uses these cases to support his main argument:

> [T]he practice by member institutions of refusing to extend credit, and the practice of extending credit on terms which are less favorable than those usually offered, to borrowers whose security property is located within a predetermined geographic area or areas, because of the location of the property, violates section 528.2(d) if such practices have a discriminatory effect against members of racial, ethnic or religious groups.

*Id.* at 2, referring to 12 C.F.R. § 528(a) (1975) (previously § 528(d)).

[10]348 F. Supp. 1130 (M.D. Fla. 1972).

court, in setting a standard to determine the existence of a pattern or practice of discrimination under Title VIII, stated:

> Any course of conduct or way of doing business which actually or predictably results in different treatment of whites and blacks is a discriminatory pattern or practice, irrespective of motivation.[11]

In *Grooms* a trailer court operator required both white and black applicants to present three references from current tenants of the park. Such references were not easily obtained by black applicants since most did not know any of the current tenants, all of whom were white. As a result of their failure to obtain the references, blacks were not admitted as tenants. Applying the standard noted above, the court held that the reference requirement was unlawful under Title VIII, emphasizing that Title VIII, like other civil rights laws, "prohibits conduct with discriminatory consequences as well as discriminatorily motivated practices."[12]

As suggested by the district court in *Grooms*, practices facially neutral which have a discriminatory effect violate civil rights laws other than Title VIII.[13] Thus, the United States Supreme Court in *Griggs v. Duke Power Co.*[14] declared unlawful an employer's promotion system that required an employee to have a high school diploma and to pass intelligence and aptitude tests in order to be eligible for promotion. Although it was not shown that the system was initiated for a discriminatory purpose, the Court held that the requirements violated Title VII of the Civil Rights Act of 1964.[15]

Title VII, like section 3605 of Title VIII, prohibits discrimination based on race, color, religion, or national origin.[16] Interpreting this prohibition, the Supreme Court in *Griggs* found that the "Act proscribes not only overt discrimination but also prac-

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[11] *Id.* at 1133.

[12] *Id.* at 1133-34.

[13] Two cases held that practices of a state which are fair in form but discriminatory in operation violate applicable provisions of the United States Constitution. Lane v. Wilson, 307 U.S. 268 (1939) (violation of the fifteenth amendment); Hobsen v. Hansen, 269 F. Supp. 401 (D.D.C. 1967) (violation of the fourteenth amendment).

[14] 401 U.S. 424 (1971).

[15] *Id.* at 432.

[16] For example, 42 U.S.C. § 2000e-2(a) (1970) provides:

> It shall be an unlawful employment practice for an employer . . . (2) to limit, segregate, or classify his employees or applicants for employment in any way which would deprive or tend to deprive any individual of employment opportunities or otherwise adversely affect his status as an employee, because of such individual's race, color, religion, sex, or national origin.

tices that are fair in form, but discriminatory in operation."[17]

In sum, a practice of redlining which has a disparate impact on minorities violates section 3605 even if the practice is based solely on the *location* of a residence and not on the race of either the applicant or inhabitants of the neighborhood. However, lending institutions that redline a minority group area may avoid liability under section 3605 if they can establish a legitimate business reason for such a policy and show that there is no less discriminatory way to accomplish this policy.[18]

### *B. Section 1982 of the 1866 Civil Rights Act*

A policy of redlining may also violate section 1982 of the Civil Rights Act of 1866.[19] Section 1982 provides: "All citizens of the United States shall have the same right . . . as is enjoyed by white citizens . . . to inherit, purchase, lease, sell, hold, and convey real and personal property."[20]

In the landmark case of *Jones v. Alfred H. Mayer Co.*,[21] the United States Supreme Court held that the scope of section 1982 extended to private acts of discrimination in the sale or rental of property and that the statute thus construed was a valid exercise of Congress' power to enforce the thirteenth amendment.[22] In upholding the constitutionality of section 1982 under the thirteenth amendment, the Court in *Jones* viewed that amendment to be a promise of freedom to black citizens which would be " 'a mere paper guarantee' if Congress were powerless to assure that a dollar in the hands of a Negro will purchase the same thing as a dollar in the hands of a white man."[23] This language suggests that redlining which has a disparate impact on black borrowers and interferes with the right to purchase a home would be proscribed by section 1982, since, because of such redlining, money in the hands of black person would not be able to purchase property that could be purchased by money in the hands of a white person.[24]

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[17]401 U.S. at 431.

[18]See note 84 *infra* & accompanying text.

[19]42 U.S.C. § 1982 (1970).

[20]*Id.*

[21]392 U.S. 409 (1968).

[22]*Id.* at 413.

[23]*Id.* at 443.

[24]The argument that section 1982 should be given a broad interpretation with focus on the *effect* of racial discrimination on the victim, rather than the act of the discriminator, is made in Note, *Discriminatory Housing Markets, Racial Unconscionability, and Section 1988: The* Contract Buyers League *Case*, 80 YALE L.J. 516 (1971). The author states:

> Just as the courts have come to acknowledge that Section 1982 does not specify possible violators [and thus is not limited to pro-

Similarly, redlining with a disparate impact on blacks which interferes with the right to rehabilitate a home should also be actionable under section 1982. This proposition is supported by the decision in *Jones* wherein the Court stated that section 1982 prohibits "all racial discrimination . . . with respect to the rights enumerated therein—including the right to purchase or lease property."[25] The denial of a rehabilitation loan to a black person would clearly interfere with that person's right to "hold" property, a right enumerated within section 1982.[26]

The proposition that section 1982 would bar racially discriminatory redlining in the extension of credit required to purchase or rehabilitate a home finds further support in the recent decision of the Seventh Circuit Court of Appeals in *Clark v. Universal Builders, Inc.*[27] The plaintiffs in *Clark* had alleged that, because of the lack of supply in the black housing market in Chicago, they were exploited by the defendants, who sold them houses for prices and on terms far in excess of those whites paid for comparable housing.[28] The Seventh Circuit, in support of its holding that plaintiffs' exploitation theory of discrimination was actionable

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> scribing discrimination committed by state action], they must soon see that the statute does not specify prohibited *acts* of discrimination, traditionally defined or otherwise. As the offspring of the Thirteenth Amendment, as well as by its own terms, Section 1982 guarantees equal property rights between the races *in fact.* The statute is addressed to whether the present status of the black man's property rights is the same as that enjoyed by white—it is oriented toward the situation of the victim of discrimination, not the acts of the discriminator. . . .

*Id.* at 559-60.

[25]392 U.S. at 436.

[26]The Supreme Court in Sullivan v. Little Hunting Park, Inc., 396 U.S. 229, 237 (1969), called for a broad interpretation of section 1982. In *Sullivan,* the defendant-corporation had refused to assign a membership share in playground facilities and a community park to Freeman, who was black. Under the corporation's bylaws, a shareholder could assign his membership share in the recreational facilities to a tenant when he rented his house, subject to approval by the board of directors. The Court found defendant's refusal to approve the attempted assignment an interference with Freeman's right to lease and, therefore, a violation of section 1982. The principle which can be drawn from *Sullivan,* then, is that the interference with the property rights guaranteed by section 1982 need not be so great that such rights are precluded from being exercised at all. Thus, a policy of redlining which has a discriminatory impact on black persons should still be actionable even if alternative, albeit more expensive, means of financing the purchase or rehabilitation of a home are available.

[27]501 F.2d 324 (7th Cir. 1974).

[28]*Id.* at 334. The Seventh Circuit found that the housing market in Chicago was racially segregated. Therefore, in reality there were two housing markets, one for whites and a separate one for blacks. In the black housing market, it was shown that the demand for housing exceeded the supply,

under section 1982,[29] noted that the Supreme Court in *Jones* "viewed section 1982 as a broad based instrument to be utilized in eliminating all discrimination and the effects thereof in the ownership of property."[30]

This interpretation of section 1982 emphasizes the effects of discrimination on the property rights of a black person. Applying the interpretation to redlining which has a disparate impact on blacks, it is clear that section 1982 should bar such a policy, since its *effect* is to preclude black citizens from exercising "the same right as is enjoyed by white persons" in "purchasing" and "holding" property.

### C. *Regulations of the Federal Home Loan Bank Board*

Though it placed the primary responsibility for administering Title VIII with the Secretary of the Department of Housing and Urban Development (HUD),[31] Congress called upon all executive agencies and departments to cooperate in administering the Act by mandating affirmative action in the administration of "programs and activities relating to housing and urban development."[32] The Federal Home Loan Bank Board (FHLBB), which regulates nearly all savings and loan associations,[33] is such an

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thereby creating the situation in which the defendant-sellers in *Clark* were able to exploit the plaintiff-buyers.

[29]*Id.*

[30]*Id.* at 330.

[31]42 U.S.C. § 3608 (1970).

[32]*Id.* § 3608(c) provides:

> All executive departments and agencies shall administer their programs and activities relating to housing and urban development in a manner affirmatively to further the purposes of this subchapter and shall cooperate with the Secretary [of HUD] to further such purposes.

[33]Approximately eighty percent of the nation's savings and loan association are FHLBS members. FEDERAL CIVIL RIGHTS ENFORCEMENT EFFORT—A REASSESSMENT, *supra* note 1, at 518. In addition, FHLBS members in 1973 held 97.7% of the assets of the savings and loan business. 1974 SAVINGS AND LOAN FACT BOOK 112 (U.S. League of Sav. Ass'ns publ. 1974). Furthermore, savings and loan associations are the major source of residential credit:

> At year-end 1973, loan portfolios of associations accounted for 48.4% of all the one-to-four family loans [loans on residential structures housing one to four families] outstanding and 26.8% of all the loans secured by multifamily units. . . . This brought associations' share of all residential mortgages to a total of 44.3%.

*Id.* at 34.

The loan portfolios of commercial banks account for 17.4% of all the one-to-four family loans outstanding in the United States, placing commercial banks second to FHLBS members in the area of residential financing. *Id.* at 38, chart 17.

agency and therefore has the duty to take affirmative action to further the purposes of Title VIII.

On April 27, 1972, the FHLBB issued "Nondiscrimination Requirements" for member institutions.[34] Section 528.2(a) of these requirements proscribes the denial of a residential mortgage or improvement loan, or the placement of discriminatory terms and conditions on these loans, because of the race of the applicant or the race of the occupants of residences located in the vicinity of the applicant's security.[35] Section 528.2(a) is based on Title VIII and sections 1981 and 1982 of the 1866 Civil Rights Act.[36] More specifically, however, the language of section 528.2(a) closely resembles the language of section 3605 of Title VIII, which prohibits discrimination in the financing of housing.[37] Therefore, in addition to proscribing a policy of redlining which has a disparate impact on blacks,[38] section 528.2(a) arguably represents a reasonable administrative interpretation of section 3605, and, as such, it should be given great deference by a court construing section 3605.[39]

## III. Redlining As a Violation of Section 1 of the Sherman Act

### A. *Elements of a Cause of Action Under Section 1*

Section 1 of the Sherman Act prohibits a combination or conspiracy in restraint of trade or commerce among the several

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[34] 12 C.F.R. § 528 (1975).

[35] *Id.* § 528.2(a) provides:

> No member institution shall deny a loan or other service rendered by the member institution for the purpose of purchasing, constructing, improving, repairing, or maintaining a dwelling, or discriminate in the fixing of the amount, interest rate, duration, application procedures, collection or enforcement procedures, or other terms or conditions of such loan or other service because of the race, color, religion, sex, or national origin of . . . (4) The present or prospective owners, lessees, tenants, or occupants of other dwellings in the vicinity of the dwelling or dwellings in relation to which such loan or other service is to be made or given.

[36] "The Applicability of the Board's Nondiscrimination Regulations to the Practice of 'Redlining' by FHL Bank Member Institutions," *supra* note 9, at 4, states:

> Section 528.2 [recodified as 528.2(a)] is based on title VIII of the Civil Rights Act of 1968 . . . and certain provisions of the Civil Rights Act of 1866 (42 U.S.C. §§ 1981, 1982) intended to ensure that all persons have an equal opportunity to rent, purchase or finance housing without regard to race, color, religion or national origin.

[37] See note 7 *supra*.

[38] See notes 9-13 *supra* & accompanying text.

[39] See Trafficante v. Metropolitan Life Ins. Co., 409 U.S. 205, 210 (1972); Griggs v. Duke Power Co., 401 U.S. 424, 433-34 (1971); United States v.

states.[40] A common and conscious pattern of business behavior among competitors (conscious parallelism) by itself is insufficient to permit an inference of a combination or conspiracy.[41] It is not clear what more is required to allow an inference that a conspiracy exists.[42] The Supreme Court, however, in a 1969 decision found a tacit agreement sufficient to establish a combination or conspiracy under section 1, concluding that each defendant gave information to the other defendants "with the *expectation* that it would be furnished *reciprocal* information when it wanted it."[43] Thus, even a small amount of contact between defendants may suffice. In any event, it is well-established that an explicit agreement is not required to allow the inference that a combination exists.[44]

A restraint on trade or commerce[45] can be shown by proving the anti-competitive effect of the disputed conduct.[46] The anti-

City of Chicago, 400 U.S. 8, 10 (1970); Udall v. Tallman, 380 U.S. 1, 16 (1965).

[40]15 U.S.C. § 1 (1970) provides that "[e]very contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade or commerce among the several States . . . is declared to be illegal . . . ."

[41]Theatre Enterprises v. Paramount, 346 U.S. 537, 541 (1954). *See also* Turner, *The Definition of Agreement Under the Sherman Act: Conscious Parallelism and Refusals to Deal*, 75 HARV. L. REV. 655 (1962). Turner notes that

> conscious parallelism is never meaningful by itself, but always assumes whatever significance it might have from additional facts. Thus, conscious parallelism is not even evidence of agreement unless there are some other facts indicating that the decisions of the alleged conspirators were *interdependent*, that the decisions were consistent with the individual self-interest of those concerned only if they all decided the same way.

*Id.* at 658 (emphasis in original).

[42]*See generally* Saliterman, *Some Antitrust Problems in Government Insured/Guaranteed Mortgage Lending*, 23 BUFF. L. REV. 119 (1973).

[43]United States v. Container Corp. of America, 393 U.S. 333, 335 (1969) (emphasis added). In *Container Corp.*, the defendants had exchanged information about the most recent price each was charging specific customers. Although the Court noted the "infrequency and irregularity" of these exchanges between the defendants and acknowledged that often the data exchanged was "available from the records of the defendants or from the customers themselves," it distinguished this behavior from conscious parallelism on the basis that each defendant expected "reciprocal information when it wanted it." *Id.*

[44]United States v. General Motors Corp., 384 U.S. 127, 142-43 (1966); United States v. Parke, Davis & Co., 362 U.S. 29, 38-44 (1960); United States v. Bausch & Lomb Optical Co., 321 U.S. 707, 723 (1944); FTC v. Beech-Nut Packing Co., 257 U.S. 441, 455 (1922).

[45]Intangibles such as mortgage or rehabilitation loans have been found to be items of "trade or commerce" within the scope of section 1. United

competitive effect of a concerted policy of redlining could be shown in at least two ways: (1) by data showing the unusually small number of residential loans granted to a redlined area vis-à-vis other areas serviced by financial institutions, or (2) by data showing onerous terms and conditions on residential loans granted in a redlined area.

Finally, the restraint on trade or commerce must have an effect on interstate commerce to be actionable under section 1. A local activity, for example, the practice of redlining in a community, which has a substantial effect on interstate commerce will satisfy this requirement.[47]

### *B. Section 1 Issues*

Three issues under section 1 of the Sherman Act are raised by a concerted refusal to grant mortgages or rehabilitation loans in a particular area or by a concerted refusal to grant such loans without onerous terms and conditions.[48]

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States v. South Eastern Underwriters Ass'n, 332 U.S. 533, 560-61 (1943); Bratcher v. Akron Area Bd. of Realtors, 381 F.2d 723, 724 (6th Cir. 1967); Contract Buyers League v. F & F Inv., 300 F. Supp. 210 (N.D. Ill. 1969).

[46]Standard Oil Co. v. United States, 221 U.S. 1, 56-68 (1911); America's Best Cinema Corp. v. Fort Wayne Newspapers, Inc., 347 F. Supp. 328, 333 (N.D. Ind. 1972).

[47]For the principle that a purely local activity which has a substantial effect on interstate commerce is sufficient to show a "restraint on trade or commerce among the several States," *see* Burke v. Ford, 389 U.S. 320 (1967); Bratcher v. Akron Area Bd. of Realtors, 381 F.2d 723 (6th Cir. 1967); Burkhead v. Phillips Petroleum Co., 308 F. Supp. 120, 124-25 (N.D. Cal. 1970); Contract Buyers League v. F & F Inv., 300 F. Supp. 210 (N.D. Ill. 1969).

[48]In Saliterman, *supra* note 42, the author discusses two residential areas of New York City which underwent rapid deterioration—eastern Brooklyn and southern Queens. The combination of a decreasing flow of conventional mortgage money into these areas and corrupt and exploitative practices by mortgage companies, real estate brokers, and the FHA in handling guaranteed government loans, often the only source of mortgages available, caused a flood of foreclosures. The foreclosures resulted in abandoned houses subject to vandalism, which in turn led to an overall decline in the quality of the neighborhoods. The author suggests four antitrust issues arising under section 1 of the Sherman Act as a result of the anti-competitive mortgage market in eastern Brooklyn and southern Queens: (1) price-fixing, (2) territory customer allocation, (3) boycotting third parties (or concerted refusals to deal), and (4) tying arrangements. A discussion of "territory customer allocation" is beyond the scope of this Note, because the data shaping this author's bias does not suggest that such a practice is necessarily connected with redlining as that policy is defined herein. It is suggested that the reader refer to the above-cited article for a discussion of the application of "territory customer allocation" to corruption-riddled lending policies of the federal government in areas where private lenders are no longer extending credit.

First, illegal price-fixing may be the result of concerted redlining policies if the price of credit in redlined neighborhoods is tampered with by horizontal price-fixing arrangements among financial institutions. A party alleging a price-fixing scheme in violation of section 1 need not show the existence of a price list or detailed verbal communication exchanges[49] or that the price levels were unreasonable, since an "intereference with the setting of price by free market forces is unlawful *per se*."[50]

Second, group boycotts or combined refusals to deal with third parties, or dealing only on onerous terms, have been held actionable under section 1 of the Sherman Act.[51] Redlining by definition involves the refusal to deal with loan applicants whose residences are located in certain areas or dealing with applicants from redlined areas on onerous terms and conditions. Therefore, a concerted policy of redlining would necessarily involve a refusal to deal which would be actionable under section 1.[52] The ultimate success in such litigation would depend on the reasonableness of the practice.[53]

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[49]United States v. Container Corp. of America, 393 U.S. 333 (1969).

[50]*Id.* at 337. *See also* United States v. McKesson & Robbins, Inc., 351 U.S. 305, 309-10 (1956); United States v. Trenton Potteries Co., 273 U.S. 392, 397-98 (1926).

[51]Eastern States Lumber Ass'n v. United States, 234 U.S. 600, 612-14 (1914); Joseph E. Seagram & Sons, Inc. v. Hawaiian Oke & Liquors, Ltd., 416 F.2d 71 (9th Cir. 1969), *cert denied,* 396 U.S. 1062 (1970); Bratcher v. Akron Area Bd. of Realtors, 381 F.2d 723, 724 (6th Cir. 1967); America's Best Cinema Corp. v. Fort Wayne Newspapers, Inc., 347 F. Supp. 328, 333 (N.D. Ind. 1972).

[52]It is well-established that individual refusals to deal in the absence of a combination are not subject to section 1 of the Sherman Act. For recent cases on point, *see* Adolph Coors Co. v. FTC, 497 F.2d 1178, 1185 (10th Cir. 1974); Colorado Pump & Supply Co. v. Febco, Inc., 472 F.2d 637, 640 (10th Cir. 1973); Eastex Aviation, Inc. v. Sperry & Hutchinson Co., 367 F. Supp. 868, 872 (E.D. Tex. 1973).

[53]E.A. McQuade Tours, Inc. v. Consolidated Air Tour Manual Comm., 467 F.2d 178, 187 (5th Cir. 1972), *cert. denied,* 409 U.S. 1109 (1973); Joseph E. Seagram & Sons, Inc. v. Hawaiian Oke & Liquors, Ltd., 416 F.2d 71 (9th Cir. 1969), *cert. denied,* 396 U.S. 1062 (1970); America's Best Cinema Corp. v. Fort Wayne Newspapers, Inc., 347 F. Supp. 328, 333 (N.D. Ind. 1972).

In *America's Best,* the district court utilized the "reasonable test" previously employed by the Ninth Circuit to determine whether a concerted refusal to deal violated section 1 of the Sherman Act, stating:

> The critical inquiry in a refusal to deal action . . . is "whether the refusal to deal, manifested by a combination or conspiracy, is so anti-competitive in purpose and effect, or both, as to be an unreasonable restraint of trade."

*Id., quoting from* Alpha Distributing Co. v. Jack Daniel Distillery, 454 F.2d 442, 452 (9th Cir. 1972).

Third, tying arrangements in extending loans to redlined areas would violate section 1 if done in concert by financial institutions.[54] Tying arrangements involve an unwillingness to sell unless the buyer purchases a second, different product:

> In order for a marketing situation to be declared an illegal tying arrangement, it is usually necessary for the seller to possess very substantial power in the "tying" or "tie-in" product. The seller then must refuse to deal with the buyer unless the buyer also purchases a second, different product, the "tied" product.[55]

The product "tied" to a mortgage extended in a redlined area may include discriminatory interest rates, high down payment requirements, or a relatively short loan life.[56]

### C. *Relief Available: Problems of Standing*

Monetary relief, including treble damages, and injunctive relief are the two major remedies available to claimants injured by violations of the antitrust laws. The former remedy, while perhaps the most desirable, can have a devastating impact on a defendant. Injunctive relief, on the other hand, does not involve the prospect of a "ruinous recovery." The following discussion of these two remedies accents the difference in the standing requirements of each and suggests that injunctive relief would be more readily available to those injured by a concerted policy of redlining.

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[54]For decisions of the Supreme Court holding tying arrangements illegal under section 1 of the Sherman Act, *see* Fortner Enterprises, Inc. v. United States Steel, 394 U.S. 495 (1969); United States v. Loews, Inc., 371 U.S. 38 (1962); Northern Pac. Ry. v. United States, 356 U.S. 1 (1958).

[55]Saliterman, *supra* note 42, at 128.

[56]The United States Supreme Court recognized credit as a tying *product* in Fortner Enterprises, Inc. v. United States Steel, 394 U.S. 495 (1969). Supporting this result the Court stated:

> The potential harm is . . . essentially the same when the tying product is credit. The buyer may have the choice of buying the tangible commodity separately [in this case, housing], but as in other cases the seller can use his power over the tying product to win customers that would otherwise have constituted a market available to competing producers of the tied product.

*Id.* at 508.

High interest rates, substantial down payment requirements, and shortened loan lives may all be attached to loans in redlined neighborhoods. It would be consistent with the *Fortner* holding for a court to view these loan terms as "products" because the potential harm—a stifling of competition in the setting of loan terms—is essentially the same as it would be if the tied products were more traditional in nature. Also, a logical extension of the recognition of credit as a product is the recognition of the terms and conditions of credit as products for purposes of insuring competition in a portion of the home financing market.

Section 4 of the Clayton Act[57] provides for monetary relief for any person injured by a violation of section 1 of the Sherman Act.

> Any person who shall be injured in his business or property by reason of anything forbidden in the antitrust laws may sue therefor in any district court of the United States . . . without respect to the amount in controversy, and shall recover threefold the damages by him sustained, and the costs of the suit, including a reasonable attorney's fee.[58]

On its face, section 4 is a broad provision which encourages an individual injured by a violation of the Sherman Act to file suit. It provides for treble damages, jurisdiction in federal court regardless of the amount in controversy, and recovery of the cost of litigation including an attorney's fee. Since its enactment in 1914, however, standing to sue under section 4 has been interpreted narrowly by courts because of a fear of "ruinous recovery" and a multitude of specious and ill-founded claims.[59] For example, the phrase "by reason of" has been interpreted to require a direct injury—the plaintiff must show a direct relationship or privity of contract with a defendant in order to have standing to sue for section 4 remedies.[60]

The Seventh Circuit Court of Appeals applied the "direct injury" test in 1963.[61] Other circuits, however, have abandoned

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[57]15 U.S.C. § 15 (1970).

[58]*Id.*

[59]*See* Note, *Standing to Sue for Treble Damages Under Section 4 of the Clayton Act,* 64 COLUM. L. REV. 570 (1964); 5 LOYOLA U.L.J. 655 (1974); 35 OHIO ST. L.J. 723 (1974). The restrictive view which courts have traditionally taken toward standing to sue for treble damages is questioned as to its virtue today, because, in taking a restrictive view, courts

> may have substantially thwarted the accomplishment of the policy goals underlying the creation of the treble damage action. . . . Moreover, judicial doctrines which are well-conceived at inception may diminish in reasonableness with the passage of time. Thus, in an era of massive concentration of economic power in the hands of "mega corporations," it may be that the potential incidence of grievous harm from anticompetitive activity warrants the extension of treble damage standing beyond its traditional, judicially-created bounds.

*Id.* at 734-35.

[60]Billy Baxter, Inc. v. Coca-Cola Co., 431 F.2d 183 (2d Cir. 1970); Nationwide Auto Appraiser Serv., Inc. v. Association of Cas. & Sur. Co., 382 F.2d 925 (10th Cir. 1967); Volasco Prod. Co. v. Lloyd A. Fry Roofing Co., 308 F.2d 383 (6th Cir. 1962); Loeb v. Eastman Kodak Co., 183 F. 704, 709 (3d Cir. 1910); Miley v. John Hancock Mut. Life Ins. Co., 148 F. Supp. 299 (D. Mass.), *aff'd per curiam,* 242 F.2d 758 (1st Cir.), *cert. denied,* 355 U.S. 828 (1957).

[61]Commonwealth Edison Co. v. Allis-Chalmers Mfg. Co., 315 F.2d 564,

this test, adopting the "target area" approach whereby plaintiff must prove that he is "within that area of the economy which is endangered by a breakdown of competitive conditions in a particular industry."[62] Although it did not rule directly on the issue, the United States Supreme Court may have indicated its preference for the "target area" approach.[63]

A second requirement of standing under section 4 is the showing of an injury to "business or property." In 1972 the Supreme Court considered the meaning of these words in *Hawaii v. Standard Oil Co.*[64] Holding that the State of Hawaii did not have standing under section 4 to recover for injuries to its general economy, the Court found that "the words 'business or property' . . . refer to *commercial* interests or enterprises."[65]

In addition, lower federal courts have held that a claimant lacks standing under section 4 if he is unable to show an injury to an *existing* business or property right.[66] This view was adopted

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567 (7th Cir.), *cert. denied,* 375 U.S. 834 (1963). In a later appeal in the same litigation, Commonwealth Edison Co. v. Allis-Chalmers Mfg. Co., 335 F.2d 203, 208 (7th Cir. 1964), the Seventh Circuit noted that its prior application of the direct injury test shielded defendants from the risk of multiple liability.

[62]Midway Enterprises, Inc. v. Petroleum Mkt'g Corp., 375 F. Supp. 1339, 1344 (D. Md. 1974). The "target area" test has been adopted by the Fourth, Eighth, and Ninth Circuits. *See In re* Western Liquid Asphalt Cases, 487 F.2d 191 (9th Cir. 1973); Sanitary Milk Producers v. Bergjans Farm Dairy, Inc., 368 F.2d 679 (8th Cir. 1966); South Carolina Council of Milk Producers, Inc. v. Newton, 360 F.2d 414 (4th Cir.), *cert. denied,* 385 U.S. 934 (1966); Karseal Corp. v. Richfield Oil Corp., 221 F.2d 358 (9th Cir. 1955).

[63]Perkins v. Standard Oil Co., 395 U.S. 642, 647 (1969). In the *Perkins* case, the appellate court held that no causal connection existed between the supplier's price discrimination and the business of a customer which was four steps removed in the distributive chain. Reversing this decision, the Supreme Court stated that the "'fourth level' limitation is wholly an artificial one and is completely unwarranted by the language or the purpose of the Act." *Id.* Although section 4 of the Clayton Act was not involved (the complaint alleged price discrimination in violation of section 2(a) of the Clayton Act), the Supreme Court's decision could be argued by analogy against a "direct injury" analysis in a section 4 claim for relief.

*Perkins* has been cited by two federal courts for the proposition that the Supreme Court has implicitly rejected the "direct injury" test for standing under section 4 of the Clayton Act. *See In re* Multidistrict Vehicle Air Pollution, 481 F.2d 122 (9th Cir.), *cert denied,* 414 U.S. 1045, *rehearing denied,* 414 U.S. 1148 (1973); Midway Enterprises, Inc. v. Petroleum Mkt'g Corp., 375 F. Supp. 1339, 1344 (D. Md. 1974).

[64]405 U.S. 251 (1972).

[65]*Id.* at 264 (emphasis added).

[66]Martin v. Phillips Petroleum Co., 365 F.2d 629 (5th Cir. 1966); Peller v. International Boxing Club, 227 F.2d 593 (7th Cir. 1955); Waldron v. British Petroleum Co., 231 F. Supp. 72 (S.D.N.Y. 1964); Brownlee v. Melco Theatres, Inc., 99 F. Supp. 312 (W.D. Ark. 1951). *See also* Note, *Standing*

by the Seventh Circuit in *Peller v. International Boxing Club*.[67] The plaintiff in *Peller* sued for treble damages, claiming that his property interests were injured when the defendants blocked his plans for the promotion of a championship boxing match. The Seventh Circuit affirmed the grant of summary judgment for the defendants and held that injury to an anticipated property right of the plaintiff could not be the basis for recovery, "inasmuch as no property rights could accrue to him . . . until and unless he succeeded in obtaining the several contractual relationships for which he was negotiating."[68]

To summarize, a plaintiff[69] seeking treble damages for a concerted policy of redlining may have to overcome three obstacles of standing to maintain his suit. First, an injury to a *commercial* interest or enterprise must be shown. Second, to claim an injury to a property interest, a claimant may be required to show that an existing property interest was injured by defendants' actions. Finally, if the suit is brought in a jurisdiction which applies the "direct-injury" test, a claimant must show that there were no intermediate actors between himself and the defendants.[70]

The prospect of showing standing to sue for injunctive relief for Sherman Act violations caused by a concerted redlining policy, however, is more promising. Section 16 of the Clayton Act[71] provides injunctive relief for those injured or about to be injured by antitrust violations:

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*to Sue for Treble Damages Under Section 4 of the Clayton Act*, 64 COLUM L. REV. 570 (1964), in which the author criticizes the court-imposed requirement of a consummated contract before a party is allowed to sue for any injury to rights to be created by a contract.

> Nor is it meaningful to draw the line at consummation of a contract or a sale. . . . The evil accomplished is the same whether the transactions were consummated or would have been but for the illegal acts. That the law of torts and of property recognize interference with such prospective economic advantage as actionable belies the proposition that recognition in this context would encourage spurious suits. Whether it would unduly expand liability is another problem, but one better solved by applying the principles of risk than by manipulating labels.

*Id.* at 586.

[67]227 F.2d 593, 596 (7th Cir. 1955).

[68]*Id.*

[69]Three separate classes of plaintiffs could be involved in a redlining suit: (1) borrowers injured by the practice, (2) home-owners, attempting to sell, injured by redlining, and (3) real estate brokers and salesmen acting as agents for the home-owners and buyers.

[70]It is arguable, however, that the Supreme Court has implicitly overruled the "direct injury" test. See note 63 *supra*.

[71]15 U.S.C. § 26 (1970).

> Any person, firm, corporation, or association shall be entitled to sue for and have injunctive relief, in any court of the United States having jurisdiction over the parties, against threatened loss or damage by a violation of the antitrust laws . . . .[72]

The "business or property" requirement of section 4 of the Clayton Act is not included in section 16. The United States Supreme Court in *Hawaii v. Standard Oil Co.*[73] dealt with this distinction. The State of Hawaii had brought suit seeking treble damages under section 4 for injuries to its general economy by defendant's alleged Sherman Act violation. Distinguishing section 4 from section 16, the Court found that the "most likely explanation" that the latter section did not require an injury to "business or property" was the essential difference between the two remedies—one hundred injunctions would have no more impact on a defendant than one, but one suit for damages could have a tremendous impact.[74]

The Court in *Hawaii* did not decide whether the State of Hawaii would have had standing under section 16, since the issue was not presented. Building on the distinction drawn by the Supreme Court in *Hawaii,* however, the Ninth Circuit Court of Appeals recently held in *In Re Multidistrict Vehicle Air Pollution*[75] that: "Unlike standing under section 4, standing under section 16 does not require an injury to 'commercial interests' but only an injury cognizable in equity."[76] Like the Supreme Court in *Hawaii,* the Ninth Circuit pointed out that the rationale for the restrictive view of standing which has been adopted in construing section 4[77] was absent in claims for injunctive relief under section 16. Section 16 does not involve the potential for "ruinous recovery," and generally attorneys' fees are not recoverable.[78]

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[72] *Id.*

[73] 405 U.S. 251, 261 (1972).

[74] *Id.* at 261-62.

[75] 481 F.2d 122, 126-31 (9th Cir. 1973).

[76] *Id.* at 130. Though not ruling specifically on different standing requirements for section 4 and section 16, a federal district court in 1969 found from the legislative history of each section that "the equitable remedy of § 16 is in no way 'predicated upon', incidental to or derived from the legal right of § 4." International Tel. & Tel. Corp. v. General Tel. & Elec. Corp., 296 F. Supp. 920, 923 (D. Hawaii 1969).

[77] *See* notes 58-69 *supra* & accompanying text.

[78] Decorative Stone Co. v. Building Trades Council, 23 F.2d 426, 428 (2d Cir. 1928); Trans World Airlines, Inc. v. Hughes, 312 F. Supp. 478, 482 (S.D.N.Y. 1970) (dictum), *modified on other grounds,* 449 F.2d 51 (2d Cir. 1971), *rev'd on other grounds,* 409 U.S. 363 (1973); Union Leader Corp. v. Newspapers of New England, Inc., 218 F. Supp. 490, 491 (D. Mass 1963) (dictum), *vacated on other grounds,* 333 F.2d 798 (1st Cir.), *cert. denied,*

Also, the threat of potential duplicative recoveries is absent under section 16.

The two groups of plaintiffs who were allowed standing in *Multidistrict* to seek injunctive relief under section 16 alleged that the defendants had conspired to eliminate all competition in the research and development of motor vehicle air pollution equipment. The farmers alleged injuries to their crop yield; the states alleged injuries to their economies.

Similar monetary injury could be shown by plaintiffs alleging anti-trust violations as a result of concerted redlining by financial institutions. For example, a class of plaintiffs denied conventional mortgages could show the added costs of alternative means of financing. A class of plaintiffs who were unable to sell their homes because of concerted redlining could show their resulting economic losses. Likewise, real estate brokers or salesmen retained by the frustrated buyers or sellers could show their loss of profits. Finally, a potential fourth class of plaintiffs could show that they suffered economically by having to abide by onerous mortgage terms to exercise their right to purchase a home in a redlined area. Therefore, because each of these potential classes of plainitffs could show monetary injury, with the two classes of borrowers in addition being able to show either the inability to live where they desire or the payment of a penalty to exercise this right, they should be able to show standing to sue for section 16 injunctive relief.

## IV. Problems in Obtaining the Legal Remedies

### A. *Problems of Proof*

Title VIII of the 1968 Civil Rights Act, section 528.2(a) of the Federal Home Loan Bank Board's regulations, and possibly section 1982 of the 1866 Civil Rights Act prohibit racial discrimination in residential lending.[79] Furthermore, it is well-established that laws prohibiting racial discrimination may be violated by practices which have a discriminatory impact, even though not motivated by racial considerations.[80] In proceedings under the civil rights laws, statistical data could be utilized to show a disparate impact on minority group persons by a financial institution's lending policies. The use of statistical data to show disparate impact has been accepted by courts in cases involving allegations of racial discrimination in employment and housing, and, in these cases, when the data establishes a prima facie case

379 U.S. 931 (1964); Alden-Rochelle, Inc. v. ASCAP, 80 F. Supp. 888, 899-900 (S.D.N.Y. 1948). *But cf.* Hall v. Cole, 412 U.S. 1 (1973) (dictum).

[79]*See* section II *supra.*

[80]See notes 9, 12-17 *supra* & accompanying text.

of a violation, the burden is placed on the defendant to come forward with evidence of non-discrimination.[81]

Thus, records of the loans granted by a financial institution, which records could be obtained through the discovery process, would enable a plaintiff to show that almost no loans were made in the minority group area where the applicant resides or intends to reside.[82] However, financial institutions may attempt to justify the denials of loans, or the inclusion of burdensome terms and conditions, as reflections of sound business judgment. Thus, an *expanded* use of statistics is advisable to eliminate or minimize the possibility that a financial institution would succeed on the de-

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[81] Statistical data has been used extensively in employment discrimination cases brought under Title VII of the 1964 Civil Rights Act. For the principle that a prima facie case is established which shifts the burden of persuasion to the defendant to show an absence of discrimination when a substantial disparity is shown between the percentage of minority persons employed by the defendant and the percentage of minority persons in the local population, *see* United States v. Chesapeake & O. Ry., 471 F.2d 582, 586 (4th Cir. 1972), *cert. denied,* 411 U.S. 939 (1973); United States v. Wood, Wire & Metal Lathers Int'l Union, 471 F.2d 408, 414 n.11 (2d Cir. 1973); Rowe v. General Motors Corp., 457 F.2d 348, 357-58 (5th Cir. 1972); United States v. Ironworkers Local 86, 443 F.2d 544, 551 (9th Cir.), *cert. denied,* 404 U.S. 984 (1971).

Statistical evidence has also been relied on in cases arising under Title VIII to determine whether a given practice is discriminatory. *See* United States v. Reddoch, P-H 1972 EQUAL OPP'TY IN HOUSING ¶ 13,569 (S.D. Ala.), *aff'd per curiam,* 467 F.2d 897 (5th Cir. 1972). In *Reddoch,* the district court took notice of the fact that defendant's apartment units had been rented to 330 families, none of whom were black, although the population of the surrounding area was thirty-five percent black. The court found that the defendants were engaged in a pattern or practice of discrimination and stated that "in cases of racial discrimination, statistics often tell much and courts listen." *See also* United States v. Real Estate Dev. Corp., 347 F. Supp. 776 (N.D. Miss. 1972) (establishment of prima facie case of discrimination shifts burden of going forward to defendants to show nondiscrimination); Newbern v. Lake Lorelei, Inc., 308 F. Supp. 407 (S.D. Ohio 1968) (court took judicial notice of absence of sales to blacks in a resort area when there was a substantial number of blacks in the population surrounding the resort development).

*See also* Bogen & Falcon, *The Use of Racial Statistics in Fair Housing Cases,* 34 MD. L. REV. 59 (1974); Fiss, *A Theory of Fair Employment Laws,* 38 U. CHI. L. REV. 235, 268-81 (1971); Montlack, *Using Statistical Evidence to Enforce the Laws Against Discrimination,* 22 CLEV. ST. L. REV. 259 (1973). Montlack in his article notes that

> in decisions rendered under Title VII of the 1964 Civil Rights Act, the weight accorded to statistical data generally reflects (1) the degree of disparity revealed, (2) the relevance of the statistical data to the issues, and (3) the sufficiency of the employer's explanations of such disparities.

*Id.* at 268.

[82] See note 81 *supra.*

fense of business necessity.[83]

The business necessity defense has been recognized in cases alleging racial discrimination in housing and employment[84] and most assuredly would be recognized in a suit alleging racially discriminatory redlining practices. Financial institutions are in business to make a profit and must evaluate the chance of losing on their investment when they consider granting a loan.[85]

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[83]The expanded statistical presentation suggested obviously would not be necessary if a financial institution, faced with a prima facie case of racial discrimination, did not come forward with a business justification for their lending policy. Therefore, its use should be restricted to rebutting a "business necessity" defense.

[84]For the recognition of "business necessity" as an affirmative defense in employment discrimination cases, see McDonnell Douglas Corp. v. Green, 411 U.S. 792, 803 (1973); Griggs v. Duke Power Co., 401 U.S. 424, 431 (1971); United States v. St. Louis - S.F. Ry., 464 F.2d 301, 308 (8th Cir. 1972), *cert. denied,* 409 U.S. 1116 (1973); United States v. Bethlehem Steel Corp., 446 F.2d 652 (2d Cir. 1971). For its recognition in housing discrimination cases, see Haythe v. Decker Realty Co., 468 F.2d 336, 338 (7th Cir. 1972); Contract Buyers League v. F & F Inv., 300 F. Supp. 210 (N.D. Ill. 1969).

In addition, the FHLBB has issued supplementary guidelines intended "to aid member institutions in developing and implementing non-discriminatory lending policies." 12 C.F.R. § 531.8 (1975). The FHLBB has also established loan underwriting standards:

> The use of lending standards which have no ecomonic basis and which are discriminatory in effect is a violation of law even in the absence of an actual intent to discriminate. However, a standard which has a discriminatory effect is not necessarily improper *if its use achieves a genuine business need which cannot be achieved by means which are not discriminatory in effect or less discriminatory in effect.*

*Id.* § 531.8(b) (emphasis added).

An important question concerning the defense of "business necessity" is whether the business justification required to be shown for a discriminatory practice must be only "reasonable" or "compelling," *i.e.,* must a financial institution show that no less discriminatory means of achieving the conceded legitimate business goal existed. The FHLBB's guidelines, quoted above in part, indicate that the standard would require a "compelling" business justification. This position, adopted in both United States v. St. Louis - S.F. Ry and United States v. Bethlehem Steel Corp., *supra,* is supported by analogy in equal protection cases which hold that a state must adopt a "less restrictive means of discriminating by classification" when a fundamental constitutional right is being interfered with or when the classification is suspect. *See* Shapiro v. Thompson, 394 U.S. 618, 634 (1969).

[85]W. Smith, Housing: The Social and Economic Elements 300-03 (1970). Smith identifies two main factors of "risk" — the probability that a lending institution will never get its entire investment returned by the borrower or his security — that a mortgage lender considers in deciding whether to extend credit. First, the lender considers the borrower's credit; second, he considers the value of the property offered as collateral. Smith also points out that "Beyond some risk level . . . the lender may feel it

Furthermore, such institutions have a duty to protect the interests of their stockholders and depositors, and it would be unreasonable to hold these institutions liable for a policy of refusing to make "bad risk" loans or, likewise, a policy of requiring a greater return on such loans by including above-average terms and conditions. In a letter to the Senate Subcommittee on Housing and Urban Affairs, which held public hearings on Title VIII of the Fair Housing Act of 1967 before its enactment,[86] Charles R. McNeill, representing the American Bankers Association, commented on business considerations or factors of risk which affect lending policies. Mr. McNeill listed a number of considerations, including the demand for various types of loans, the ability of the borrower to repay the loan, and the assurance that the security is of sufficient value to cover potential losses in the case of default by the debtor.[87] These risk factors would be the elements of a lending institution's attempt to establish an affirmative defense of "business necessity."

Thus, the plaintiff alleging racially discriminatory redlining practices would be wise to expand his statistical presentation to show more than a substantial disparity in the number and amount of loans between white residential areas and black residential areas. A suggested goal of the plaintiff's statistical inquiry would be to show that the area where the plaintiff resides or wishes to reside is comparable to an area inhabited primarily by white persons in which the institution is making mortgages and rehabilitation loans.[88] Statistical data necessary to reach this goal would include information on the income level of the two areas, the age and structural soundness of housing in each area, the ability of residents in each area to get home-owner's insurance, and any other ascertainable factors which would negate the suggestion that redlining is the result of sound business judgment.[89]

In proceedings under the Sherman Act, the plaintiff is faced with the problem of establishing standing to sue for damages.[90]

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necessary to require progressively higher yields [by adjusting loan terms and conditions accordingly] to compensate for additional risk. . . ." *Id.* at 301.

[86]*Hearings on S. 1358, S. 2114 and S. 2280 Before the Subcomm. on Housing and Urban Affairs of the Senate Comm. on Banking and Currency,* 90th Cong., 1st Sess. (1967).

[87]*Id.* at 484.

[88]An analogous use of statistical data has been approved by courts in housing and employment discrimination cases. *See* note 81 *supra. See also* Clark v. Universal Builders, Inc., 501 F.2d 324, 337-38 (7th Cir. 1974).

[89]As is noted earlier in this Note, the lender is concerned with the borrower's credit and ability to repay the loan. A plaintiff in a redlining suit therefore would also want data available for rebuttal showing an ability to repay the loan comparable to the ability of those granted loans.

[90]See section III *supra.*

If injunctive relief is sought, the plaintiff must prove that a Sherman Act violation has been or is about to be committed.[91] Business necessity, an affirmative defense in a civil rights action, has also been recognized as an affirmative defense to practices otherwise illegal under the Sherman Act.[92] Thus, similar problems of proof may arise in a civil rights proceeding and in a Sherman Act proceeding.

### B. *Practical Considerations*

In addition to the suggested problems of proof, litigation contesting the practice of redlining poses difficult collateral issues.[93] First, inasmuch as the Sherman Act and the civil rights laws have never been applied to redlining activities, litigation would involve the formulation and resolution of novel questions of law and fact, and success would be difficult to predict.

Second, although preliminary injunctive relief may often be available and the mere initiation of a lawsuit may have a positive remedial influence, the claimant or claimants may need an abundance of patience and money, since it could take years for a final decision to emerge from the appellate process. This factor is particularly important, since the defendant in a redlining suit would likely be able to afford the best counsel, who would be formidable opponents in a lengthy and complex suit.

Finally, neither the civil rights laws nor the Sherman Act provide wholly satisfactory relief against redlining. The civil

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[91]15 U.S.C. § 26 (1973).

[92]E.A. McQuade Tours, Inc. v. Consolidated Air Tour Manual Comm., 467 F.2d 178, 187-88 (5th Cir. 1972), *cert. denied*, 409 U.S. 1109 (1973); Joseph E. Seagram & Sons, Inc. v. Hawaiian Oke & Liquors, Ltd., 416 F.2d 71 (9th Cir. 1969), *cert. denied*, 396 U.S. 1062 (1970).

The Fifth Circuit in *McQuade* was presented with the issue of whether defendant's refusal to deal with the plaintiff was reasonable. The court found that it was, after reviewing defendant's reasons, and stated: "These interests all represent legitimate business objectives of . . . [the defendant]. There is not the slighted suggestion that the rules of the road were meant to serve any but the objectives stated." 467 F.2d at 188.

[93]The remedies available to a successful party under section 3605 of Title VIII are listed at 42 U.S.C. § 3612(c) (1970). They include injunctive relief, "actual damages and not more than $1,000 punitive damages, together with court costs and reasonable attorney fees." For remedies available to the successful litigant under section 1982 of the 1866 Civil Rights Act, see Sullivan v. Little Hunting Park Inc., 396 U.S. 229, 238-40 (1969). In *Sullivan* the Supreme Court held that discriminators are liable to victims for monetary damages for injuries caused by their illegal conduct under section 1982. *See also*, Note, *Racial Discrimination in the Private Housing Sector: Five Years After*, 33 MD. L. REV. 289, 295-98 (1973); Note, *Discriminatory Housing Markets, Racial Unconscionability, and Section 1988: The* Contract Buyers League *Case*, 80 YALE L.J. 516 (1972); 50 TEXAS L. REV. 204 (1971).

rights laws apply only in cases of racial discrimination; the Sherman Act applies only when a conspiracy or combination can be proved. The practice of redlining might not involve either of these two elements.

## V. Some Alternative Remedial Approaches

### A. *Action by the Attorney General*

Section 3613 of Title VIII authorizes the Attorney General to initiate suits in two different factual settings. First, he may bring an action if he has "reasonable cause to believe" that a person or group of persons is engaged in a "pattern or practice" of resistance to the terms of Title VIII. Second, he may bring suit when any group of persons has been denied any rights granted by Title VIII and when "such a denial raises an issue of general public importance."[94]

The redlining of black areas, actionable under section 3605 of Title VIII, fits well into either factual setting. The evidently widespread nature of the practice appears to qualify redlining as "an issue of general public importance"—a determination which the courts usually leave to the discretion of the Attorney General.[95] Also, whether practiced individually or by a combination of financial institutions, redlining involves a "pattern" of resistance to the terms of section 3605 of Title VIII.

In light of the expense and the complexity of the issues involved in an action contesting a practice of redlining, the advantages of a suit by the Justice Department vis-à-vis litigation by private claimants are obvious. It should also be noted that section 3613 authorizes the Attorney General to seek such protective

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[94]42 U.S.C. § 3613 (1970) provides:

> Whenever the Attorney General has reasonable cause to believe that any person or group of persons is engaged in a pattern or practice of resistance to the full enjoyment of any of the rights granted by this subchapter, or that any group of persons has been denied any of the rights granted by this subchapter and such denial raises an issue of general public importance, he may bring a civil action in any appropriate United States district court by filing with it a complaint setting forth the facts and requesting such preventive relief, including an application for a permanent or temporary injunction, restraining order, or other order against the person or persons responsible for such pattern or practice or denial of rights, as he deems necessary to insure the full enjoyment of the rights granted by this subchapter.

[95]United States v. Northside Realty Associaties, Inc., 474 F.2d 1164, 1168 (5th Cir. 1973); United States v. Bob Lawrence Realty, Inc., 474 F.2d 115, 125 n.14 (5th Cir.), *cert. denied,* 414 U.S. 826 (1973); Cornelius v. City of Parma, 374 F. Supp. 730, 744 n.18 (N.D. Ohio 1974). *But see* United States v. Hunter, 459 F.2d 205, 217 (4th Cir. 1972).

relief—including a permanent or temporary injunction or restraining order—"as he deems necessary to insure the full enjoyment of the rights granted" by Title VIII.[96]

### *B. Legislation*

The City Council of the City of Chicago passed a unique ordinance on June 10, 1974.[97] This ordinance requires banks and savings and loan associations to supply "residential lending information" with annual bids that they submit to the City Controller for interest upon public funds of the City.[98] Section 7-34

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[96]See note 94 *supra.*

[97]CHICAGO, ILL., CODE §§ 7-30 to 7-35 (1974).

[98]Similar legislation has recently been introduced in the United States Senate by Senators Proxmire, Brooks, and Stevenson. S. 1281, 94th Cong., 1st Sess. (1975). The bill would require disclosure by each financial institution in the business of making federally related mortgage loans which has a home or branch office located within a standard metropolitan statistical area (SMSA). As of this writing S. 1281 has been passed by the Senate and is under consideration in the House. Features of S. 1281 include:

> (1) a finding by Congress that "depository institutions have sometimes failed to provide adequate home financing on a nondiscriminatory basis for all neighborhoods within the communities and neighborhoods from which those institutions receive deposits;"
>
> (2) a requirement that the affected institutions compile annually *for public inspection and copying at each office of the affected institutions,* the number and total dollar amount of mortgage loans, by census tract, for borrowers under mortgage loans secured by property located within and outside the relevant SMSA;
>
> (3) authority, to be vested in the Board of Governors of the Federal Reserve System, to "prescribe such regulations as may be necessary to carry out the purposes of this Act;"
>
> (4) enforcement powers, to be vested in the four federal financial regulatory agencies and the FTC, to insure compliance with the requirements imposed under S. 1281;
>
> (5) authorization of a study by the Board of Governors of the Federal Reserve System and the Secretary of HUD to determine (a) the feasibility of requiring "depository institutions" located outside a SMSA to make disclosures comparable to those required by S. 1281; (b) the feasibility, cost, and usefulness of requiring all institutions covered by S. 1281 "to disclose by geographical location the source of savings deposits;" (c) "the feasibility and usefulness of requiring disclosure of other types of lending data, such as small business and home improvement loans;" and (d) "the practicality of requiring disclosure of the average terms and downpayment ratios of mortgage loans by geographical location."

S. 1281 does not require as detailed a disclosure as the Chicago ordinance, although the feasibility of requiring disclosure on home improvement loans and savings deposits by amount and area is to be studied, as noted above. The advantage of S. 1281 is that it applies to *all* financial institutions within a given SMSA making federally related mortgage loans. Thus, it requires in-

generally sets forth the information to be submitted by each bidder, which consists of the number and total amount of all residential loans, and the weighted average interest rate and down payment thereon, made within the City of Chicago and the six-county Chicago Standard Metropolitan Area.

Section 7-34(a)(vi) of the ordinance requires more specific information, including the number, total amount, and terms and conditions of conventional and FHA-VA real estate loans made in each census tract within Chicago. Parts (vii) and (viii) of section 7-34 require bidders to report the number and total amount of all construction and home improvement or rehabilitation loans made on residential properties within each census tract of Chicago.[99]

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voluntary disclosures whereas the Chicago ordinance requires disclosures of only those institutions submitting bids on city and school funds.

[99]CHICAGO, ILL., CODE § 7-34 (1974) provides:

> With each bid for interest upon City and school funds, the Comptroller shall obtain, in a form prescribed by him from each bidder, the lending and deposit information for its home office and for each branch office or facility the following information:
>
> a) Residential lending information: The following information to be reported on residential loans shall be classified separately for property containing (1) dwelling units for not more than four families and condominium and cooperative units; and (2) dwelling units for more than four families in the aggregate. Only loans closed within the previous calendar year shall be reported.
>
> i) The number and total amount of all loans made on residential property within the City of Chicago.
>
> ii) The number and total amount of all loans made on residential property outside the City of Chicago, but located in the six county Chicago Standard Metropolitan Statistical Area (SMSA), which includes DuPage, Kane, Will, McHenry and Lake.
>
> iii) The weighted average effective interest rate for all loans made on residential property within the City of Chicago.
>
> iv) The weighted average effective interest rate for all loans made on residential property outside the City of Chicago, but located in the six county Chicago SMSA.
>
> v) The weighted average down payment as a percent of all loan amounts made (1) within the City of Chicago as classified by census tract; and (2) outside the City of Chicago, but limited to the six county Chicago SMSA.
>
> vi) The following data on conventional and FHA-VA residential loans shall be reported for each census tract within the City of Chicago:
>
> a) The number of:
> —conventional real estate loans
> —FHA/VA real estate loans
>
> b) The total original amount of:
> —conventional real estate loans
> —FHA/VA real estate loans

The information required by section 7-34 of this ordinance will provide the City Controller with data that could aid in documenting a pattern of redlining within Chicago by a bidder. However, the ordinance does not require further investigation by the City Controller (or any other city agency or official) in cases where the "residential lending information" submitted suggests that a bidder is redlining certain areas of Chicago; nor does it contain sanctions against any bidder shown to be engaged in redlining.

The Commissioner of the Illinois Savings and Loan Association, on January 17, 1974, announced amendments to existing

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c) The weighted average down payment as a percentage of:
—conventional real estate loans
—FHA/VA real estate loans
d) The average amount of:
—conventional real estate loans
—FHA/VA real estate loans
e) The weighted average effective interest rate for:
—conventional real estate loans
—FHA/VA real estate loans
f) The weighted average term in years for:
—conventional real estate loans
—FHA/VA real estate loans

vii) The number and total amount of all construction loans made on residential properties within each census tract in the City of Chicago.
viii) The number and total amounts of all home improvements or rehabilitation loans made on residential properties within each census tract in the City of Chicago.

b) Consumer lending information:
i) The number and total amount of all consumer loans made within the City of Chicago.
ii) The number and total amount of all consumer loans made within each census tract in the City of Chicago.
iii) The number and total amount of all consumer loans made outside Chicago but limited to the six county SMSA.

c) Commercial lending information:
i) The number and total amount of all commercial loans made within the City of Chicago.
ii) The number and total amount of all commercial loans made within each census tract in the City of Chicago.
iii) The number and total amount of all commercial loans made outside Chicago but limited to the six county SMSA.

d) Savings and checking account information:
The number of savings accounts and checking accounts and the total dollar balances in the savings and checking accounts, stated separately, as of December 31 for each census tract within the City of Chicago.

e) OPTIONAL—Each bidder may submit such additional material that is deemed relevant to consideration of his bid. For example, such additional material may include specific information as to

regulations of his agency, in which it is announced that discrimination and redlining are prohibited.[100] The new regulations require the retention of records of each proposed borrower's application and provide that each association member "shall maintain each loan application rejected and the information in support thereof, for a period of twenty-four (24) months following such rejection."[101]

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the activity during the preceding calendar year of the bidder and its corporate affiliates in:

i) The interim financing of low and middle-income housing in the City of Chicago.

ii) The purchase of City of Chicago, Board of Education, and Public Building Commission bonds and Board of Education tax notes and warrants.

The approach suggested by the Chicago ordinance to mitigate the practice of redlining by banks and trust companies in Indiana could be utilized by amending existing state law. The Depositary Act of 1937, IND. CODE §§ 5-12-1-1 *et seq.* (Burns 1974), controls the designation of depositories for the public funds of the state and municipalities in Indiana. This statute requires any bank or trust company to file "proposals" with the local County Board of Finance for municipal funds and with the State Board of Finance for state funds.

These "proposals" are simple forms which require only the most basic information from the bank or trust company, such as the location of the bank's offiices and total resources of the bank. Any recommendation that they be revised to include residential lending information like that required by the Chicago ordinance would have to be congruent with the purpose of the Depository Act. *See* IND. CODE § 5-12-1-15(b) (Burns 1974). Since the Act contains no reference to the lending practices of depositories wishing to receive public funds of either the state or municipalities, a recommendation that "proposals" include residential lending information would not be congruent with the Act as it is presently written.

[100]These amendments revised regulations issued pursuant to the Illinois Savings and Loan Act, ILL. ANN. STAT. ch. 32, §§ 805, 841.2 (1970):

Article IV, § 3(b). Record retention:

(1) Each association shall determine the financial ability of every proposed borrower or other person to become personally liable to the association before issuing its commitment, and thereafter each association shall maintain all loan applications and the supporting documentation as part of the records of the association.

(2) Each association, that has been so directed by the Commissioner, pursuant to Section 2 of Article IV of the Rules and Regulations shall maintain each loan application rejected and the information in support thereof, for a period of twenty-four (24) months following such rejection.

. . . .

Article VI. §2. Discrimination and Redlining Prohibited.

(a) It shall be considered discriminatory to refuse to grant mortgage loans, to arbitrarily vary the terms of those loans or the application procedures for those loans because of: in the case of the proposed borrower, his race, color, religion, national origin, age, sex, marital status; in the case of the proposed collateral, its geographic location.

[101]*Id.* Art. IV, § 3(b) (2).

### *C. Federal Financial Regulatory Agencies*

Four federal financial regulatory agencies—the Federal Home Loan Bank Board (FHLBB), the Board of Governors of the Federal Reserve System (FRB), the Comptroller of the Currency (COC), and the Federal Deposit Insurance Corporation (FDIC)—together regulate almost all the nation's banks and savings and loan associations.[102] HUD, in a March 1974 publication, stated that these regulatory agencies should improve their processes of examining member institutions. Two means of achieving improvement are suggested by HUD. First, HUD suggests that racial and ethnic data on loan applications should be kept by lenders because, "[w]ithout this data, an examiner's efforts [to uncover discriminatory lending practices] can be little more than educated guesswork."[103] Second, HUD proposes that "[e]xaminer training programs . . . be strengthened to prepare examiners to monitor adequately the more subtle forms of discrimination, such as 'redlining' and unfair application of credit standards."[104]

Closer regulatory supervision to insure compliance with section 3605 of Title VIII and legislation proscribing redlining per se would complement the remedial approach to redlining offered by litigation. Closer supervision may provide the most effective means of deterring redlining, since it would involve an on-going scrutiny of the regulated institutions' lending practices. Legislation would outlaw redlining practiced in predominantly white neighborhoods.

## VII. Conclusion

Redlining is a controversial and complex issue. Those who condemn the practice point to neighborhood deterioration and decay as its end product.[105] Lending institutions, while denying that such a practice exists, generally are unwilling to substantiate their denials by data concerning their lending habits.[106] This

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[102]Federal Civil Rights Enforcement Effort — A Reassessment, *supra* note 1, at 160.

[103]U.S. Dept of Housing and Urban Development, Housing and Urban Development Trends 159 (1974).

[104]*Id.*

[105]"Coalition to End Neighborhood Deterioration, Why Do Neighborhoods Deteriorate? Redlining in Indianapolis" (1974). This report contains information on the lack of conventional mortgage money in central city neighborhoods in Indianapolis and the cycle of deterioration that results therefrom.

[106]*See* Note, *Redlining—The Fight Against Discrimination in Mortgage Lending*, 6 Loyola U.L.J. 71 (1975); Indianapolis News, Feb. 20, 1975, at 22, col. 3; Indianapolis News, May 3, 1974, at 37, col. 1; Indianapolis Star, Apr. 11, 1974, at 53, col. 1; Wall Street Journal, Apr. 5, 1974, at 1, col. 1; Indianapolis News, Mar. 26, 1974 at 34, col. 2.

unwillingness has created a situation comparable to the proverbial Catch 22.

Although the discovery process in any redlining litigation could provide the claimants with data to document the practice, litigation would be expensive and time consuming with unpredictable results. Legislation requiring disclosure and at the same time prohibiting redlining is certainly desirable. The Chicago ordinance or the regulation issued by the Illinois Savings and Loan Commissioner could serve as models for such legislation.

Finally, financial institutions, which enjoy privileges and rights unavailable to other institutions by virtue of state or federal charters, should provide for a ventilation of the facts by publicly disclosing residential lending information similar to that required by the recently enacted Chicago ordinance. Confidentiality of the records could be provided for by proper arrangements. If financial institutions are not redlining, such a disclosure could be used to rebut erroneous attacks on their lending practices. However, if disclosure revealed that some institutions were not investing or investing very little in certain neighborhoods, an explanation to the public for such a disparity would be warranted.

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# Errata

Page 557, sixteenth line. For "The court found the law firm liable," read "The court found the law firm potentially liable."